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United States
Circuit Court of Appeals
For the Ninth Circuit

CLARANCE A. REES and EVELYN E. REES,
bankrupts,

Appellants,

JENSEN, Individually, and as Executrix
the Estate of SOREN N. JENSEN, Deceased,

Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States
for the Western District of Washington,
Northern Division

FILED

MAR 26 1948

PAUL P. O'BRIEN,
CLERK



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No. 11830

**United States
Circuit Court of Appeals
for the Ninth Circuit**

**CLARANCE A. REES and EVELYN E. REES,
bankrupts,**
Appellants,

vs.

**SOREN N. JENSEN and ANNA JENSEN,
Appellees.**

Transcript of Record

**Upon Appeal from the District Court of the United States
for the Western District of Washington,
Northern Division**

INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

| | PAGE |
|---|----------|
| Appeal: | |
| Certificate of Clerk to Transcript of Record on | 28 |
| Notice of | 28 |
| Statement of Points on..... | 82 |
| Attorneys | 1 |
| Certificate of Clerk to Transcript of Record on Appeal | 28 |
| Court's Oral Decision | 23 |
| Discharge of Bankrupt | 20 |
| Exhibits for Bankrupt: | |
| No. 1—Notice of Trial Amendment..... | 30 |
| Motion and Affidavit to Amend Summons and Complaint by Adding a New Party and New Cause of Action | 31 |
| Amended Complaint | 36 |
| Amended Answer of Defendants, Rees | 49 |

Exhibits for Bankrupt—(Continued):

| | |
|---|-----------|
| No. 2—Face of Real Estate Contract Between Cora Skirving, Grantor, and Clarence A. Rees and Evelyn E. Rees, Grantees | 61 |
| Letter of M. L. Longfellow to S. N. Jensen and E. D. Gordon, 2/26/44 | 64 |
| No. 3—Findings of Fact and Conclusions of Law | 65 |
| No. 4—Decree | 79 |
| Findings of Fact and Conclusions of Law..... | 13 |
| Conclusions of Law | 18 |
| Findings of Fact | 14 |
| Notice of Apel | 28 |
| Order Sustaining Decision of Referee..... | 21 |
| Referee's Certificate on Review..... | 2 |
| Referee's Decision on Objections to Release from Judgment | 6 |
| Statement of Points | 82 |

ATTORNEYS

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Counsel for Judgment Creditors—Appellees,

LADY WILLIE FORBUS,
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Seattle, Washington.

In the District Court of the United States for the
Western District of Washington, Northern
Division

In Bankruptcy, No. 37440 (Re-opened)

In the Matter of

CLARENCE A. REES and EVELYN E. REES,
a marital community,
Bankrupts.

REFEREE'S CERTIFICATE ON REVIEW

To the Honorable Lloyd L. Black, United States
District Judge:

I, Van C. Griffin, Referee in Bankruptcy in
charge of this proceeding, do hereby certify:

That in the course of such proceedings, pursuant
to a hearing on the objections of Soren N. Jensen
and Anna Jensen, his wife, to the discharge of the
bankrupts from a liability evidenced by a judgment
in the Superior Court of King County, Washington,
an order was made and entered on the 23rd day of
May, 1947, denying discharge as to that certain
judgment debt of Soren N. Jensen and Anna Jen-
sen, his wife, and the marital community composed
of them, in Cause No. 352943 in the Superior Court
of King County, Washington, and granting dis-
charge as to the remainder.

That on the 29th day of May, 1947, the bankrupts,
feeling aggrieved thereat, filed their petition for
review, setting forth therein the errors of which
he complained.

Summary of Evidence

Soren N. Jensen and Anna Jensen, his wife, filed objections to the discharge of the bankrupts on the ground that their debt was not dischargeable in bankruptcy as being founded upon a wilful and malicious injury to their property. The [4*] matter came on for hearing on April 18, 1947, at which time the bankrupt, Clarence A. Rees, was present in person and was represented by his attorneys. The hearing was continued and the matter came up again regularly on May 6, 1947, at which time it was stipulated in open court by Mary A. Burrus, one of the attorneys for the bankrupts, and Lady Willie Forbus, attorney for the objecting creditors, that the issue raised by the objectors could properly be considered by the Referee and that he could decide said issue. This stipulation was made because of the somewhat involved and perplexing question as to whether or not the objection may properly be presented to the Bankruptcy Court or should be reserved for decision by the court which entered the judgment.

No oral evidence was offered by anyone at the hearing. There was offered and received in evidence from the record in the case of Jensen vs. Rees, Cause No. 352943 in the Superior Court of King County, Washington, the following exhibits:

Bankrupts' Exhibit 1, Photostatic copies

Bankrupts' Exhibit 2, Photostatic copies

* Page numbering appearing at foot of page of original certified Transcript of Record

Bankrupts' Exhibit 3, Copies of Findings of Fact and Conclusions of Law.

Bankrupts' Exhibit 4, Copy of Decree

Creditors' Exhibit 5 consists of copies of certain records of the King County Property Agent, and was offered and received in evidence by the Referee, who reserved his ruling thereon and later decided the only evidence of any probative value in said exhibit was a notation on the last page thereof that there were no improvements, and that there is no statute making the work sheets of the County Property Agent constructive notice to the public. Therefore, in his opinion the Referee disregarded that exhibit.

The Referee heard oral argument from the attorneys of [5] the respective parties, considered their briefs submitted in support of their several contentions and rendered his decision on objections to release from judgment and made and entered his Findings of Fact, Conclusions of Law, and Order of Discharge of Bankrupt. The contents of all said documents appear from the originals which are herewith transmitted.

Papers Transmitted

1. Objections to Discharge of Bankrupts.
2. Referee's Decision on Objections to Release from Judgment.
3. Findings of Fact and Conclusions of Law.
4. Discharge of Bankrupt.
5. Bankrupts' Petition for Review.

6. Bankrupts' Proposed Summary of Evidence Adduced on Hearing of Objections to Discharge.
7. Authorities submitted by attorneys for bankrupts.
8. Memorandum of Authorities on Question of Debts Not Affected by Discharge of Bankrupts submitted by attorney for creditors.
9. Answering Brief of Clarence A. and Evelyn E. Rees.
10. Supplemental brief of Judgment Creditors.
11. Reply Brief.
12. Bankrupts' Exhibit 1.
13. Bankrupts' Exhibit 2.
14. Bankrupts' Exhibit 3.
15. Bankrupts' Exhibit 4.
16. Creditors' Exhibit 5.

Dated at Seattle, in said District, this 8th day of July, 1947.

Respectfully submitted,
VAN C. GRIFFIN,
Referee in Bankruptcy.

[Endorsed]: Filed July 8, 1947. [6]

[Title of District Court and Cause]

REFEREE'S DECISION ON OBJECTIONS TO RELEASE FROM JUDGMENT

Soren N. Jensen and Anna Jensen, his wife, filed objections to the discharge of the bankrupts from a liability to them evidenced by a judgment in the Superior Court of King County, Washington. In response to notice of hearing, the creditors appeared by their attorney, Lady Willie Forbus, and the bankrupts appeared by Clarence A. Rees, one of the bankrupts, and by David J. Williams and Mary E. Burrus, their attorneys, and in open court stipulated that the issues raised by the objectors could properly be considered by the Referee and that he could decide said issues.

Certified copies of the Findings of Fact, Conclusions of Law, and Decree were offered and received in evidence without objection, and there were offered certified copies of other documents to which objections were made, but all of the offered documents were admitted in evidence with the understanding that their competency, materiality, and probative value would be re-considered in hearing arguments upon and passing upon the merits of the case.

Engaging oral arguments were made at the hearing and exhaustive briefs were filed by the attorneys for the bankrupts and the objecting creditors. The Referee has read with keen interest the many authorities cited, which cover a large number [9] of subjects and cases in which some rather fine distinc-

tions are made, and there may not be complete harmony in all the decided cases. However, the question here presented is really quite simple, and it is this:

Was the obligation upon which the creditors' judgment was based one for wilful and malicious injuries to property, and is it, therefore, not dischargeable in bankruptcy under Section 17 of the Bankruptcy Act?

The authorities are well-nigh uniform to the effect that a mere conversion of property does not necessarily amount to a wilful and malicious injury, and that in considering the nature of the acts or transactions upon which the liability and judgment rest, consideration may be given to the entire record in the case and if there is any ambiguity or uncertainty, evidence may be offered even outside of the record.

The only exhibit or evidence outside of the record which the Referee might have considered as having probative value was the fifth page of the Creditor's Exhibit 5, which was a certified copy of a work sheet of the King County Property Agent, which contained a notation that there were no improvements. Inasmuch as the Referee knows of no statute making the work sheets of the County Property Agent constructive notice to the public and there was no oral evidence that the contents of this document were brought to the attention of the bankrupts, he has disregarded that exhibit.

Of great and controlling importance in this case are the facts that the buildings belonging to the

Jensens and converted by the Rees' were personal property, had been severed from the realty in a lien foreclosure against "Doc" Hamilton, [10] and had been physically removed from the place they were originally constructed and probably mistakenly placed upon Tax Lot 4, which gave rise to this litigation. It is more logical to believe that when Clarence A. Rees filed his application to purchase Tax Lot 4 (Bankrupts' Exhibit 2, page 5), and made his bid therefore, the sum of \$50.00, that he was bidding for the land and not for the buildings, which of themselves were worth \$1,000.00 or more. These circumstances and the fact that the bankrupts did not avail themselves of the privilege of taking the witness stand and explaining what motives they had or what possible justifications they could have in converting to their own use the personal property of the judgment creditors, leaves the Findings of Fact and Conclusions of Law upon which the judgment is based unanswerable. (Bankrupts' Ex. 3 & 4).

"Findings of Fact

XVII.

"* * * That the houses, sheds, barns and each structure now upon said North 65 feet have been at all times considered as personality by the Plaintiffs and the Defendant Skirving; and that at the time of her sale of said property, to the Defendants, Clarence A. Rees and wife, said structures were not included in the sale and no consideration was given for them, or

either of them. That the Defendants Rees and wife never at any time believed they were purchasing said structures, or either of them, having been advised at the time of their purchase, that the buildings were no part of the property purchased.

XVIII.

“That notwithstanding the facts hereinabove set out, the Defendants, Clarence A. Rees and Evelyn A. Rees, his wife, on or about January 20, 1944, took possession of all and every one of the structures hereinabove mentioned, moved into the house and ejected the Plaintiffs’ tenants therefrom, and in all respects converted said property to their own uses; and denied the use or possession of same to Plaintiffs and their tenants; and continue to do so up to the present time, although the Plaintiffs collected rent thereon for January and February, 1944, and their tenants remained in possession of said houses during said period. [11]

XIX.

“That the fair market value of the house and other structures upon the North 65 feet of the Defendant Skirving’s property so converted by the Defendants’, Rees and wife, at the time of the conversion on or about January 20, 1944, was \$1,000.00.

Conclusions of Law:

“IV.

“That the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, have converted personal property belonging to the Plaintiffs, consisting of a house, shed, barn and other structures situated on the North 65 feet of the Defendants' property, which property was so located thereon by agreement of the Plaintiffs and Defendant Skirving, and was at all times considered as personal property in which the Defendant Skirving never at any time claimed an interest, and was not sold to the Defendants Rees and no consideration was paid by the Defendants Rees therefor.

That the Defendants Rees and wife have become unjustly and unlawfully enriched by their conversion of Plaintiffs' buildings in the amount of \$1,000.00, and Plaintiffs are entitled to judgment therefor.”

The principle of law which this Referee thinks is controlling in this case was well expressed in the case of *In re Freche*, 109 Fed. Rep. 620:

“From the nature of the case the act * * * which caused the injury was wilful, because it was voluntary. The act was unlawful, wrongful and tortious, and, being wilfully done, it was, in law, malicious. It was malicious because the injurious consequences which followed the wrongful act were those which might naturally be expected to result from it, and which the

defendant must be presumed to have had in mind when he committed the offense. ‘Malice’ in law simply means a depraved inclination on the part of a person to disregard the rights of others, which intent is manifested by his injurious acts. While it may be true that in his unlawful act Freche was not actuated by hatred or revenge or passion towards the plaintiff, nevertheless, if he acted wantonly against what any man of reasonable intelligence must have known to be contrary to his duty, and purposely prejudicial and injurious to another, the law will imply malice * * *.

“The judgment here mentioned comes, as we think, within the language of the statutes reasonably construed * * *.” [12]

See also:

Tinker v. Colwell, 193 U. S. 463;
Remington on Bankruptcy, Vol. 7, 813;
Bever v. Swecker, 116 NW 704;
Smith v. Ladrie, 6, ABR NS 218.
6, ABR NS 218.

The case of Emigh v. Lohnes, 21 Wash. (2) 913, is relied upon and extensive excerpts quoted, but a reading of that case will disclose that the facts of that case were very different from the facts in this case. In fact, that was not a judgment based upon conversion at all and, therefore, the decision in that case could have little or no influence on the decision in this case. However, in the decision

of this Emigh case there is an extensive quotation from the case of *In re La Porte*, 54 Fed. Suppl. 911, but the decision of this last-named case does not go any further than to hold that wilful and malicious injury does not follow as a matter of course from every act of conversion. There are many cases cited in the answering brief of the bankrupts in which the liability was based upon conversion, but the facts of which would not establish a wilful and malicious injury to property. Where the original taking is rightful, as where one loans property to another, and then without fault of the borrower the property is destroyed, there would be in law a conversion but it would not be wilful and malicious injury to property. In the case of *Brown v. Garey*, 196 NE 12, cited and quoted from in the brief of bankrupts, it was pointed out that the courts must examine the circumstances of each particular case and say whether it finds among them the elements which the law has come to accept as badges of wilfulness and legal malice. If a brokerage firm which accepts securities for safe-keeping and is trustee for the owner co-mingles these and pledges them as its own for a loan or sells them, it is guilty of malicious [13] injury to property, but a brokerage company with many employees who keeps its own securities and those of its customers segregated, but by some inadvertance a customer's securities are pledged for the broker's loan, the broker would be guilty of conversion but not malicious injury to property.

In this case the Reeses did not come into possession of this personal property by the consent of the owner, nor by inadvertence. The Findings of Fact and Conclusions of Law above quoted negative any contention that when they bought the property they thought the buildings were attached thereto as realty and that they were, therefore, the owners thereof. They did not so testify and the evidence established that they designedly obtained possession of these buildings and converted them to their own use and, therefore, the judgment based upon said conversion is not dischargeable in bankruptcy.

Findings of Fact and order may be presented in accordance with this decision.

Dated at Seattle, this 15th day of May, 1947.

VAN C. GRIFFIN,
Referee in Bankruptcy.

[Endorsed]: Filed July 8, 1947. [14]

[Title of District Court and Cause.]

FINDINGS OF FACT AND CONCLUSIONS
OF LAW

This Matter coming on for hearing on May 6, 1947, before the Undersigned Referee in Bankruptcy, pursuant to order fixing hearing thereon, having been continued from April 18, 1947, upon the objections of Soren N. Jensen and Anna Jensen, his wife, and the marital community composed of them, judgment creditors of the above-named bankrupts, upon the ground that their judgment

listed among the provable debts of the bankrupts is not dischargeable in bankruptcy under Section 17 of the Bankruptcy Act; the bankrupts appearing in person and through their attorneys of record, Colvin & Williams and Mary E. Burrus, and the judgment creditors appearing in person and through their attorney of record, Lady Willie Forbus, and the Trustee heretofore appointed by the Court, Kenneth S. Treadwell, appearing in person; and the bankrupts and judgment creditors having stipulated in open court at the hearing on April 18, 1947, that the Referee assume jurisdiction and determine the dischargeability of the judgment debt; and the parties hereto having submitted certain Exhibits to the Court, and having also submitted exhaustive briefs upon the questions of law involved in the proceeding; and the Referee having considered the objections to the Exhibits and deferred his ruling thereon and announced that the whole matter would be taken under advisement and a written opinion filed herein, thereupon heard the oral argument of counsel; and now having read and considered the briefs of all counsel, and considered the objections to certain [15] Exhibits, and having heretofore filed its memorandum opinion herein, and being further fully advised in the premises, now, therefore, the Court hereby makes the following

Findings of Fact

I.

That the judgment creditors herein obtained a judgment against the bankrupts on June 5, 1945, in

the Superior Court of King County, Washington, in Cause No. 352943, for \$1000.00 damages and \$64.90 court costs, which said judgment remained unsatisfied at the time the judgment creditors were adjudged bankrupt. That said judgment is listed among the debts of the bankrupts, from which they seek a discharge.

II.

That the judgment was based upon a suit for damages for the intentional and unlawful conversion of certain buildings belonging to the judgment creditors situated upon real property purchased by the bankrupts, which buildings were severed from the realty and were considered and known to all the parties, including the bankrupts, to be the personal property of the judgment creditors, and were not included in the sale of the real estate, and no consideration was paid therefor.

These facts are borne out by the Findings of Fact and Conclusions of Law of the King County Superior Court, upon which the judgment was based and which have been admitted in certified form by agreement of the parties hereto as Exhibits 3 and 4 before this Court, pertinent portions of which are as follows:

“Findings of Fact XVII.

“* * * That the houses, sheds, barns and each structure now upon said North 65 feet have been at all times considered as personality by the Plaintiffs and the Defendant Skirving; and

that at the time of her sale of said property, to the Defendants, Clarance A. Rees and wife, [16] said structures were not included in the sale and no consideration was given for them, or either of them. That the Defendants Rees and wife never at any time believed they were purchasing said structures, or either of them, having been advised at the time of their purchase, that the buildings were no part of the property purchased.

XVIII.

“That notwithstanding the facts hereinabove set out, the Defendants, Clarance A. Rees and Evelyn A. Rees, his wife, on or about January 20, 1944, took possession of all and every one of the structures hereinabove mentioned, moved into the house and ejected the Plaintiffs’ tenants therefrom, and in all respects converted said property to their own uses; and denied the use or possession of same to Plaintiffs and their tenants; and continue to do so up to the present time, although the Plaintiffs collected rent thereon for January and February, 1944, and their tenants remained in possession of said houses during said period.

XIX.

“That the fair market value of the house and other structures upon the North 65 feet of the Defendant Skirving’s property so converted by the Defendants, Rees and wife, at the time of the conversion on or about January 20, 1944, was \$1,000.00.

“Conclusions of Law

IV.

“That the Defendants, Clarance A. Rees and Evelyn E. Rees, his wife, have converted personal property belonging to the Plaintiffs, consisting of a house, shed, barn and other structures situated on the North 65 feet of the Defendants' property, which property was so located thereon by agreement of the Plaintiffs and Defendant Skirving, and was at all times considered as personal property in which the Defendant Skirving never at any time claimed an interest, and was not so sold to the Defendants' Rees and no consideration was paid by the Defendants Rees **therefor.**

“That the Defendants Rees and wife, have become unjustly and unlawfully enriched by their conversion of Plaintiffs' buildings in the amount of \$1,000.00, and Plaintiffs are entitled to judgment therefor.”

That upon the facts submitted to this Court and the above Findings and Conclusions, the bankrupts took the personal property of the judgment creditors, knowing it to be their property, and intentionally used it and continue to use it as their own and now assert ownership of it. [17]

III.

That among the exhibits offered at the hearing of this matter was Judgment Creditors' Exhibit No. 5, consisting of a certified copy of a work sheet

of the King County Property Agent, which contained a notation that there were no improvements upon Lot 4 which was property adjoining the Skirving property (on which the buildings were situated) purchased by the bankrupts, and which property the bankrupts made application to purchase for \$50.00 from King County just after they had acquired the Skirving property. It was offered for the purpose of showing that the bankrupts knew they were purchasing vacant land and that the buildings were not on Tax Lot 4.

The bankrupts objected to the introduction of the Exhibit on the ground that it was not a part of the original record in the Superior Court action.

There is no statute making the work sheets of a county property agent constructive notice to the public; and there was no evidence introduced at the hearing to show that the contents of that portion of the Exhibit was ever brought to the attention of the bankrupts.

Dated and Done in Open Court this May 23,
1947.

VAN C. GRIFFIN,
Referee in Bankruptcy.

And from the foregoing Findings of Fact, the Court makes the following

Conclusions of Law

I.

That the facts upon which the judgment of the King County [18] Superior Court were based and the facts presented to this Court show a wilful

and intentional conversion of the judgment creditors' property, and constitute a wilful and malicious injury to their property; and the judgment debt is, therefore, not dischargeable in bankruptcy; and the judgment creditors are entitled to an order excluding their judgment from the provable debts of the bankrupts.

II.

That the objection of the bankrupts to the introduction of Exhibit No. 5 of the judgment creditors is sustained, and the Exhibit is refused in evidence.

III.

To all of which Findings and Conclusions the Bankrupt Rees excepts.

Dated and Done in Open Court this May 23, 1947.

VAN C. GRIFFIN,
Referee in Bankruptcy.

Presented by

/s/ LADY WILLIE FORBUS,
Attorney for Judgment
Creditors.

Copy Received May 19, 1947. Colvin & Williams,
Attorneys.

Copy mailed by agreement May 19, 1947. Kenneth S. Treadwell, Trustee.

[Endorsed]: Filed July 8, 1947. [19]

[Title of District Court and Cause.]

DISCHARGE OF BANKRUPT

At Seattle, in said District, on the 23rd day of May, 1947.

It appearing that Clarence A. Rees and Evelyn E. Rees, a marital community, of Kent, in the County of King, State of Washington, were duly adjudged bankrupts on a petition filed by them on the 10th day of April, 1946, and that said bankrupts appeared and were examined at a meeting of creditors concerning all matters which might affect the administration and settlement of their estate and their application for and the granting of their discharge; and

It further appearing that, after due notice by mail, objections to the discharge of said bankrupts from the judgment debt of Soren N. Jensen and Anna Jensen, his wife, and the marital community composed of them, were filed within the time fixed by the court, were heard upon notice as required by law, and were sustained,

It is ordered that the said Clarence A. Rees and Evelyn E. Rees, a marital community, be and they hereby are discharged from all debts and claims which are by the Act of Congress relating to bankruptcy made provable by said Act against their estate, except such debts as are, by said Act, excepted from the operation of a discharge in bankruptcy, and in particular except that certain judgment debt of Soren N. Jensen and Anna Jensen, [20] his wife, and the marital community composed

of them, in Cause No. 352943 in the Superior Court of King County, Washington, in the amount of \$1,064.90. That the Bankrupts Rees except to each and every Finding and Conclusion and to the whole thereof of said Findings and to the exemption of the debt to said creditors Jensen from the discharge herein.

VAN C. GRIFFIN,
Referee in Bankruptcy.

Presented by:

LADY WILLIE FORBUS,
Attorney for Soren N. Jensen
and Anna Jensen, His Wife.

[Endorsed]: Filed July 8, 1947. [21]

[Title of District Court and Cause.]

**ORDER SUSTAINING DECISION
OF REFEREE**

This Matter having come on for hearing before the Honorable Lloyd L. Black, one of the judges of the above-entitled Court, on August 6th, 1947, upon the Bankrupts' appeal from the decision of the Honorable Van C. Griffin, Referee in Bankruptcy, dated May 23, 1947, excepting from discharge of the bankrupts a certain judgment debt of Soren N. Jensen and Anna Jensen, his wife, and the marital community composed of them, in Cause No. 352943 in the Superior Court of King County, Washington, in the amount of \$1064.90, the Bankrupts

appearing in person and by their counsel, Colvin & Williams and Mary E. Burrus, and the judgment debtors, appearing in person and by their counsel, Lady Willie Forbus; whereupon the Court proceeded with the hearing; and each counsel having argued the facts and the law to the Court, and having submitted written briefs in support thereof, the Court thereupon took the matter under advisement; and thereafter the Court on September 30, 1947, having orally announced in open court in the presence of counsel and their representatives that the decision of the Referee dated May 23, 1947, is sustained: [77]

Now, Therefore, Be It Hereby Ordered, Adjudged and Decreed That the decision of Van C. Griffin, Referee in Bankruptcy of May 23, 1947, excepting from discharge the judgment debt of Soren N. Jensen and Anna Jensen, his wife, and the marital community composed of them, in Cause No. 352943 in the Superior Court of King County, Washington, in the amount of \$1064.90, be and the same hereby is sustained.

Done in Open Court this 13th day of October, 1947.

LLOYD L. BLACK,
Judge.

Presented by

/s/ LADY WILLIE FORBUS,
Attorney.

[Endorsed]: Filed Oct. 13, 1947. [78]

[Title of District Court and Cause.]

COURT'S ORAL DECISION

September 30, 1947

Black, J.

The Court: I have asked counsel in two matters to attend at this time. One is in connection with the action of United States of America versus Gephart and wife. Are counsel present in that matter?

Mr. Dennis: Yes, your Honor.

Mr. Todd: Yes, your Honor.

The Court: The other is in connection with the petition for review in the bankruptcy matter of Clarence A. Rees and Evelyn E. Rees as a marital community. Who are present?

Mr. Williams: I represent the bankrupt, if your Honor please.

A Woman Spectator (In Rear of Court Room): Judge Black's secretary said I could come for Lady Forbus. I am in her office.

The Court: You are her secretary? You, too, may come forward. [79]

I am going to take up the matter of the Rees bankruptcy first because what I have to say is going to be less lengthy.

This matter has been before the Court for some time, having been submitted to the Court in August. In brief, the referee, upon the stipulation of counsel both for the bankrupts and for the objecting creditors that he might decide the effect of the discharge as against a judgment debt of Soren N. Jensen and Anna Jensen, his wife, did make a decision.

Pursuant to that decision, he entered a discharge which specifically recited that that certain judgment debt of Soren N. Jensen and Anna Jensen, his wife, and the marital community composed thereof in cause No. 352,943 in the Superior Court of the State of Washington for King County in the amount of \$1,064.90 was not covered by the discharge. The bankrupts petitioned for a writ of review. Such discharge was entered on May 23, 1947. The bankrupts and the judgment creditors agreed as aforesaid that the Referee in Bankruptcy might and should determine the effect of the discharge.

The bankrupts are not complaining that the Referee acted. The bankrupts on the contrary state that the Referee acted incorrectly.

I have given serious consideration to the records of the entire bankruptcy matter and to the records as admitted [80] in evidence in the Superior Court action upon which the judgment of Mr. and Mrs. Jensen was based. I have also given serious consideration to the respective briefs of the parties and been aided by the oral argument which was presented to me in August.

If the matter were before me as a matter of first impression and without restriction by judicial decisions of courts which bind me, I would have no great difficulty.

Section 35 of Title 11, U.S.C.A., provides insofar as applicable:

“A discharge in bankruptcy shall release a bankrupt from all of his provable debts,

whether allowable in full or in part, except such as * * * (2) are liabilities * * * for wilful and malicious injury to the person or property of another."

With no decisions to guide my course, I am inclined to believe that I would consider that language as not protecting the judgment of Mr. and Mrs. Jensen. But I am bound and controlled by a forest of authority. The weight of authority is to the effect that those simple words include intentional conversation of the kind which Judge Ronald in his findings determined occurred on the part of the bankrupts as against the property of Mr. and Mrs. Jensen. As a result, I feel [81] that in the light of the authorities which control me I must sustain, and therefore I do sustain the decision of the Referee.

The opinion of the Referee as found in the files displays that sufficient study of authorities and consideration of the findings of the Superior Court judge as make unnecessary any substantial discourse by me.

It may be that had I heard all the evidence which was presented to Judge Ronald I might have come to a different conclusion. On the other hand, had I heard it all, I might have decided as did he, and I might have entered findings of fact which were substantial duplicates of those which he signed.

If Judge Ronald were mistaken, the remedy for Mr. and Mrs. Rees was by appeal to the state supreme court. No appeal was taken.

I may say this further, that the matter has been before me preliminarily to such a substantial extent that I was quite well acquainted with the authorities and with the arguments prior to its submission to the Referee. In the first place, the bankrupts asked for the privilege of amending their schedules so as to show the correct address of judgment creditors. This application for amendment was most vigorously contested by counsel for the judgment creditors, who contended the Court had no authority to allow an [82] amendment. I decided that in favor of the bankrupts' feeling that under the showing made the allowance of amendment was fair and equitable. Subsequently, but very shortly thereafter, application was again made to the Court by the bankrupts for an order of this Court restraining further garnishment proceedings. Even more vigorous opposition, if that be possible, was made by Senator Forbus contending I had no authority. I decided that contention against her, among other things, for the reasons set forth in my oral decision of November 26, the transcript of which appears in the file. I said, "It seems to me that until the bankrupts have had a reasonable opportunity to secure, if they are entitled to secure, a discharge based on the amendment, that the bankrupts should not be harassed in this forum and in another forum at the same time."

I made it clear on that day that I was not obligating myself to do more than what I could to avoid a multiplicity of actions and a multiplicity

of forums at the same time. I believe that my rulings both as to the amendment and as to the restraining order were correct. The law gave the bankrupts an opportunity to have their day in court and their day in a single court so that they might present their contentions without the threat of some other court acting simultaneously. In other words, I recognize [83] that in law as well as in physics the same body cannot occupy two spaces at the same time.

I feel I have no right to go further. I would not be justified in overruling the Referee by virtue of the feeling that I have that were there no decisions controlling me that my opinion might be different. I can and will say that I am not absolutely certain that the Referee was correct. However, the records here, the arguments and the authorities sufficiently indicate that he is correct that I would have no right to reverse his conclusion. I am not indicating that my mind is evenly balanced as to whether or not the Referee is correct. Even in that event I take it that I should allow his ruling to stand. I will go further and say that I think it considerably more probable that he is right than that he is mistaken. So, of course, his decision is sustained.

Thank you for coming.

[Endorsed]: Filed Oct. 13, 1947. [84]

[Title of District Court and Cause.]

NOTICE OF APPEAL

To Soren N. Jensen and Anna Jensen, his wife, Respondents, and Lady Willie Forbus, their attorney, and to the Clerk of the Above-Entitled Court:

Notice Is Hereby Given that Clarence A. Rees and Evelyn E. Rees, his wife, bankrupts above-named, hereby appeal to the Circuit Court of Appeals for the Ninth Circuit from the order entered in the above cause by the Honorable Lloyd Black on the 13th day of October, 1947, insofar as said order sustains the Referee's decision excepting the debt of respondents, Soren N. Jensen and Anna Jensen, his wife, from discharge in bankruptcy.

COLVIN & WILLIAMS,
Attorneys for Petitioners.

[Endorsed]: Filed Oct. 15, 1947. [87]

[Title of District Court and Cause.]

**CERTIFICATE OF CLERK TO TRANSCRIPT
OF RECORD ON APPEAL**

United States of America,
Western District of Washington—ss.

I, Millard P. Thomas, Clerk of the United States District Court for the Western District of Washington, do hereby certify that the foregoing type-written transcript of record, consisting of pages numbered 4 to 96, inclusive, is a full, true and complete copy of so much of the record, papers and other proceedings in the above and foregoing entitled cause as is required by the Stipulation and

Designation of Contents of Record on Appeal filed and shown herein, as the same remain of record and on file in the office of the Clerk of said District Court at Seattle and that the same, together with Bankrupts' Exhibits numbered 1 to 4, inclusive, and Creditors' Exhibit numbered 5, the originals of which are sent up as a part of this record in accordance with the stipulated order of the Court, constitute the record on appeal from the Judgment of said United States District Court for the Western District of Washington to the United States Circuit Court of Appeals for the Ninth Circuit, dated October 13, 1947.

I further certify that the following is a true and correct statement of all expenses, costs, fees and charges incurred in my office for preparing record on appeal [97] herein to the United States Circuit Court of Appeals for the Ninth Circuit, to-wit:

Clerk's fees for making record, certificate or return:

| | |
|--------------------------|---------|
| None pages at 40c..... | \$ |
| 93 pages at 10c..... | 9.30 |
| Appeal fee (Notice)..... | 5.00 |
| Total | \$14.30 |

I further certify that the costs of this record have been paid by the attorneys for appellants.

In Witness Whereof I have hereunto set my hand and affixed the official seal of said District Court at Seattle, in said District, this 9th day of January, 1948.

[Seal] MILLARD P. THOMAS,
Clerk,
By /s/ TRUMAN EGGER,
Chief Deputy.

BANKRUPTS' EXHIBIT No. 1

In the Superior Court of the State of Washington
for King County

No. 352943

SOREN N. JENSEN and ANNA JENSEN, Hus-
band and Wife,

Plaintiffs,

vs.

CLARENCE A. REES and EVELYN E. REES,
Husband and Wife,

Defendants.

NOTICE OF TRIAL AMENDMENT

Notice Is Hereby Given that at the opening of the trial on the merits in the above entitled matter on September 5th, 1944, defendants will ask leave to amend their Answer and Affirmative Defense to allege that the property involved in this action was not improved by a five-room dwelling house or any dwelling house whatsoever and it had no improvements except possibly one or two sheds of little or no value on said property.

[Seal] /s/ DAVID J. WILLIAMS and
 MARY E. BURRUS,

Attorneys for Defendants.

660 Central Building,
Seattle 4, Washington.

[Endorsed]: Filed August 31, 1944.

Bankrupts' Exhibit No. 1—(Continued)

In the Superior Court of the State of Washington
for King County

No. 352943

SOREN N. JENSEN and ANNA JENSEN, Husband and Wife,

Plaintiffs,

vs.

**CLARENCE A. REES and EVELYN E. REES,
Husband and Wife,**

Defendants.

MOTION TO AMEND SUMMONS AND COMPLAINT BY ADDING A NEW PARTY, AND NEW CAUSE OF ACTION.

Come now the Plaintiffs, through their attorney of record, Lady Willie Forbus, and move the Court for leave to amend the Summons and Complaint in the above entitled action by adding one Cora J. Nessly, also known as Cora J. Skirving, as an additional Defendant herein, with proper words and allegations to charge her; and to plead a new cause of action to conform to certain newly discovered proof for the recovery of the real property and improvements involved in this action.

This motion is based upon the records and files in the above entitled action, certain surveys in the

Bankrupts' Exhibit No. 1—(Continued)
office of the County Engineer of King County,
Washington, and upon the affidavit of Plaintiffs'
counsel hereto attached.

LADY WILLIE FORBUS,
Attorney for Plaintiffs, 1601 Northern Life Tower,
Seattle, Washington.

State of Washington,
County of King—ss.

Lady Willie Forbus, being first duly sworn, upon oath deposes and says:

That she is the Attorney of record for the Plaintiffs in the above entitled action.

That this is an action in equity to set aside a certain County Treasurer's Tax Deed issued to the Defendants herein covering certain property allegedly belonging to the Plaintiffs, and to forever quiet title to the property described in said tax deed in the Plaintiffs.

That at the time suit was brought and the issues framed by the litigating parties, it was the belief of all said parties Plaintiffs and Defendants that certain improvements, consisting of a five-room house, outhouse and sheds of the reasonable value of approximately \$2,000.00, were located upon the property described in the Tax Deed and likewise described in Plaintiffs' and Defendants' pleadings.

That an official and professional survey of the property described therein now reveals that the improvements alleged in the pleadings are not within

Bankrupts' Exhibit No. 1—(Continued)

the boundaries of said property, but, on the other hand, said improvements are located upon the property of the owner of the land adjoining to the South and approximately sixty-five (65) feet distant from the boundary line of the property involved in this litigation.

That one Cora J. Nessly, now known as Cora J. Skirving, is the owner of the legal title to the adjoining property.

That the said Cora J. Nessly, now Skirving, sold said adjoining property on real estate contract to the Defendants in this action on or about January 13, 1944, and that said contract is in force at the present time, no deed having been issued by her to Defendants up to the present time.

That at the time of the sale on contract by said adjoining property owner to Defendants, no mention was made of the improvements upon said land; and at no time was there within the contemplation of the parties that any improvements existed upon the property or any consideration was being paid therefor.

That, on the other hand, the Plaintiffs and the Defendants and the said Cora J. Nessly, now Skirving, at all times believed that the improvements were upon the property of the Plaintiffs involved in the Tax Deed and in this litigation; and that Defendants have just prior to the trial of this action, and upon discovery of the facts set out herein, given notice to Plaintiffs that they will ask leave to amend their Answer and affirmative defense so as

Bankrupts' Exhibit No. 1—(Continued)

to deny that the aforesaid improvements are upon the property of Plaintiffs described in the Tax Deed and in this litigation.

That the improvements described therein are actually situated, according to survey, upon the North 65 feet of the Southwest Quarter of the Northeast Quarter of Section 2, Township 21 North, Range 5 E. W. M., lying Southeasterly of the Northern Pacific Railway Right of Way and Westerly of Jenkins Creek, in King County, State of Washington, which property is included in the adjoining property sold by Cora J. Nessly, now Skirving, to Defendants.

That since June, 1929, a period of sixteen years, the Plaintiffs herein have been in open, notorious, continuous possession of the aforesaid north 65 feet, without let or hindrance, interference or claim of any nature whatsoever of the said Cora J. Nessly, now Skirving, with her personal knowledge, and remained in possession and continuously claimed title and ownership of said property from June, 1929, until just prior to the institution of this action when the Defendants ejected Plaintiffs' tenants therefrom and took forcible possession of same.

That Plaintiffs have acquired title to the aforesaid North 65 feet by adverse possession from the said Cora J. Nessly, now Skirving, and the Defendants herein, and is entitled to have her title to said property quieted against her and the Defendants and the whole world.

Bankrupts' Exhibit No. 1—(Continued)

That in order to have a full determination of the rights of all the parties to this action, and in order to avoid a multiplicity of suits, it is necessary that the said Cora J. Nessly, now Skirving, be joined as an additional Defendant herein; and that the aforesaid North 65 feet of the Southwest Quarter of the Northeast Quarter, lying Southeasterly of the Northern Pacific Right of Way and Westerly of Jenkins Creek, situated in Section 2, Township 21 North, Range 5 East, W. M., King County, State of Washington, be included in the property covered in this litigation; and that Plaintiffs be permitted to add as an additional cause of action against the Defendants herein and the newly joined Defendant, Cora J. Nessly, now Skirving, the aforesaid and additional facts to establish her right to have the aforesaid property and the improvements thereon set aside to her and quieted in her, free of any right, title, or interest of the Defendants or Cora J. Nessly, now Skirving, to same.

That this motion is not made to hinder or delay the trial of this action. That Plaintiffs desire a speedy determination of their rights and offer to file an amended complaint within a period of three days, or such shorter time as the Court may require. That their sole reasons for interposing this motion is to have a complete determination of the controversy between the parties and all parties in interest and to avoid another suit to establish their right to

Bankrupts' Exhibit No. 1—(Continued)
the North 65 feet of the adjoining property and
their improvements thereon.

LADY WILLIE FORBUS.

Sworn to and Subscribed before me on this Sep-
tember 2nd, 1944.

GERALD W. MEIER,
Notary Public, in and for the State of Washington,
residing in Seattle.

[Endorsed]: Filed September 2, 1944.

In the Superior Court of the State of Washington
for King County

No. 352943

(In Equity)

SOREN N. JENSEN and ANNA JENSEN, Hus-
band and Wife, Plaintiffs,

vs.

CLARENCE A. REES and EVELYN E. REES,
Husband and Wife, and CORA J. NESSLY,
now CORA J. SKIRVING,

Defendants.

AMENDED COMPLAINT

Come now the Plaintiffs and for a first cause of
action against the Defendants allege:

I.

That Plaintiffs and Defendants are now and dur-
ing the times herein mentioned have been residents
of King County, Washington.

Bankrupts' Exhibit No. 1—(Continued)

II.

That on or about June 14, 1929, Plaintiffs purchased on real estate contract, from the Seattle Development Company of Seattle, Washington, the following described property:

That portion of Government Lot No. 2, Section 2, Township 21 North, Range 5 East W. M., lying Southeasterly of the Northern Pacific Railway Company's right of way and the West 330 feet of that portion of Government Lot No. 1, of said Section 2, lying southerly of said right of way, all in King County, Washington.

That said contract was recorded June 27, 1929, in Vol. 1435 of Deeds, page 409, under Auditor's File No. 2545354, records of the office of County Auditor of King County, Washington.

III.

That at the time Plaintiffs purchased the aforesaid property on real estate contract as above set out, the National City Bank of Seattle, Washington, held a first real estate mortgage upon the same; and that said mortgage was thereafter foreclosed in Cause No. 236197 of the Superior Court of King County, Washington, a decree of foreclosure having been entered therein in due course.

That thereafter and on or about December 19, 1931, said property was offered for sale at public

Bankrupts' Exhibit No. 1—(Continued)
auction in satisfaction of the judgment aforesaid, whereupon the Plaintiffs became the best and highest bidder for the same, and thereafter on January 22, 1932, the Superior Court of King County ordered the sale confirmed. That thereafter the Sheriff of King County issued a Sheriff's Deed to Plaintiffs covering said property, which deed was recorded on December 20th, 1932, in Volume 1518 of Deeds, page 201, records of the County Auditor of King County, Washington, under Auditor's file No. 2744699.

IV.

That in the year 1928 the aforesaid property was segregated by the Assessor's office of King County, Washington, as follows:

(a) That portion of said Government Lot 2, lying southeasterly of the Northern Pacific Railroad Company right of way and Westerly of the James B. Kline Road, Section 2, Township 21 North, Range E. W. W. M., situated in King County, Washington, being known as Tax Lot No. 4.

(b) That portion of said Government Lot 2, lying southeasterly of the Northern Pacific Railroad Company right of way and Easterly of the James B. Kline Road, together with the West 330 feet of Government Lot 1, lying southerly of said railroad right of way, situated in King County, Washington, being known as Tax Lot No. 46.

Bankrupts' Exhibit No. 1—(Continued)

V.

That both the real estate contract issued in 1929 and the Sheriff's Deed issued in 1932, to Plaintiffs, contained the legal description set out in Paragraph II as one single tract.

That at no time during the times hereinbefore or hereinafter mentioned, did the Plaintiffs learn of the segregation of their property into Tax Lot No. 4 and Tax Lot No. 46; nor did they learn of said segregation until just prior to the institution of this action.

VI.

That during the year 1929, after the Plaintiffs purchased the aforesaid property, one Edna D. Hanson purchased the vendor's equity in Sub-division (b) above, being Tax Lot No. 46, from the Seattle Development Company, subject to Plaintiffs' contract of purchase.

VII.

That the general taxes on Tax Lot No. 46, being Subdivision (b) above, were paid December 31, 1929, by the said Edna D. Hanson or her agents, and thereafter by the Plaintiffs in this action.

That the general taxes on Tax Lot No. 4, being Subdivision (a) above, were unpaid for the years 1924 to 1927, inclusive, and on June 25th, 1930, King County foreclosed its certificate of delinquency for said general taxes in Cause No. 232197, Superior

Bankrupts' Exhibit No. 1—(Continued)

Court of King County, Washington, which action proceeded to judgment and a tax deed covering Tax Lot No. 4 was issued to said King County on April 21st, 1932, as shown by King County Auditor's File No. 2718790, records of King County. That Plaintiffs had no knowledge of the facts herein set out until just prior to the institution of this action.

VIII.

That during the month of March, or thereabouts, 1930, Plaintiffs went to the King County Treasurer's office at the Courthouse in Seattle, Washington, and requested a tax statement of all their general taxes due to date, and offered to pay the same, having cash in his hands so to do. That the Plaintiff, Soren N. Jensen, was then and there informed by the Deputy Treasurer on duty in the office at the time, that the taxes had been paid by the said Edna D. Hanson, through her father John A. Hanson; and that no taxes were then due at the time.

That being ignorant of any segregation and with no knowledge that taxes then due on Tax Lot No. 4 (Subdivision (a) herein) had not been paid, being misled and relying upon the statements made to him by the Deputy Treasurer, the Plaintiff left the office without paying the same.

That being still without knowledge of any segregation and relying upon the statements made to him by the County Treasurer of King County, the Plaintiffs continued to pay from year to year the taxes shown upon tax statements issued out of the

Bankrupts' Exhibit No. 1—(Continued)
office of the County Treasurer, at all times believing that the property described therein was all of the property of the parties purchased on contract.

IX.

That since June 14, 1929, when Plaintiffs acquired the aforesaid property and up to the present time, Plaintiffs have been in the continuous, open and uninterrupted possession of said property.

X.

That said property consists of vacant, pasture land of approximately 1.5 acres.

XI.

That on or about January 20, 1944, King County conveyed to the Defendants herein under Tax Deed from the Treasurer of King County, recorded January 24, 1944, in Volume 2196 of Deeds, Page 528, under Auditor's File No. 3361972, records of said County, the property acquired by foreclosure on April 21st, 1932, as follows:

- (a) That portion of said Government Lot 2, lying Southeasterly of the Northern Pacific Railroad right of way and Westerly of the James B. Kinne Road, Section 2, Township 21 North, Range 5 E W M, situated in King County, Washington, being known as Tax Lot No. 4.

said Defendants being Clarence A. Rees and Evelyn E. Reese, his wife.

Bankrupts' Exhibit No. 1—(Continued)

That said sale was made without the knowledge of Plaintiffs, and they did not learn of any of the transactions connected with the acquisition of said property or its sale to the Defendants, Clarence E. Rees and Evelyn E. Rees, his wife, until on or about the 14th day of January, 1944, when the Defendant, Clarence A. Rees, demanded immediate possession of said property from the Plaintiffs and their tenants.

XII.

That the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, paid to King County Treasurer the sum of Fifty (50) Dollars for said property, together with the costs of sale thereof, amounting to approximately \$9.00.

That at the time of the purchase of said property the Defendants Rees and wife knew the value of said property to be greatly in excess of the amount paid, and also knew that Plaintiffs were ignorant of the pending proceedings for the sale of said property by the Treasurer to them.

XIII.

That at the time of the issuance of the deed to Defendants Rees and wife, the Plaintiffs had tenants upon said property and that Defendants Rees and wife demanded that said tenants immediately leave the premises and deliver up physical possession to them; and that immediately thereafter the

Bankrupts' Exhibit No. 1—(Continued)

Defendants Rees and wife occupied the same and so occupy it at the present time, over the objections of Plaintiffs.

XIV.

That the Plaintiffs tender herewith the sum of One Hundred (100) Dollars, to repay Defendants Rees and wife for all sums expended by them in payment for the land and all other necessary expenses incurred by them in connection therewith, and hereby offer to pay any further sums unforeseen by Plaintiffs at this time for the purpose of reimbursing the Defendants Rees and wife in full for all necessary sums by them paid.

XV.

That the Plaintiffs are now being denied full use and enjoyment of their property by the Defendants Rees and wife; that said Defendants have unlawfully and wrongfully taken possession of said property, and unlawfully and wrongfully withhold said property from Plaintiffs.

And as a second cause of action, Plaintiffs allege:

I.

That at the time Plaintiffs acquired the aforesaid property on June 14, 1929, and later by Sheriff's deed on December 20, 1932, the Defendant, Cora J. Skirving, then Cora J. Nessly owned the following described land adjoining Plaintiffs' above described Tax Lot No. 4 along the south boundary line thereof, to-wit:

Bankrupts' Exhibit No. 1—(Continued)

That portion of the Southeast Quarter of the Northwest quarter of Section 2, Township 21 North, Range 5 East W M, lying East of the Northern Pacific Railway Right of Way; and the West 990 feet of the Southwest Quarter of the Northeast Quarter of said Section, Less the Northern Pacific Railway Right of Way; and Less the South 660 feet of the East 660 feet; Less portion of the North 660 feet lying Easterly of Jenkins Creek; and Less portion of the South 330 feet of the West 330 feet lying Easterly of Jenkins Creek, Together with a right of way for road over that portion of the North 25 feet of the Southwest Quarter of the Northeast Quarter lying between Jenkins Creek and Soos Creek-Berrydale Road; Except roads, situated in King County, Washington.

II.

That on or about January 13, 1944, the Defendant, Cora J. Skirving, formerly Cora J. Nessly, sold the aforesaid property on real estate contract to the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, which said contract was recorded in the office of the County Auditor of King County, Washington, on April 10, 1944, in Volume 2218 of Deeds, at page 397, under Auditor's File 3378923, records of said County.

That said Defendant, Cora J. Skirving, formerly Nessly, delivered possession of said property to the

Bankrupts' Exhibit No. 1—(Continued)

Defendants Rees and wife, who immediately thereafter took possession of same and are in possession at the present time.

III.

That since on or about June 14, 1929, a period of approximately sixteen years, Plaintiffs have been in open, notorious, continuous possession of the North sixty-five (65) feet of the property hereinabove described in Paragraph I of Plaintiffs' Second Cause of Action herein, without let or hindrance, interference or claim of any nature whatsoever of the said Defendant, Cora J. Skirving, formerly Cora J. Nessly, with her personal knowledge.

That Plaintiffs during said time built and maintained roads and driveways thereon, pastured their cows, and built, moved onto, and maintained a five room house, outhouses and sheds thereon, rented said property to tenants and collected rentals thereon, and in all manner and ways exercised ownership of said property and remained in possession and continuously claimed title and ownership of said North 65 feet until just prior to the institution of this action when the Defendants Rees and wife ejected Plaintiffs' tenants therefrom and took forcible possession of same from Plaintiffs.

That Plaintiffs have held said North 65 feet of the property described in Paragraph I of this Second Cause of Action adversely to the Defendant, Cora J. Skirving, formerly Cora J. Nessly, and the Defendants Rees and wife since June 14, 1929, and

Bankrupts' Exhibit No. 1—(Continued)
now claim ownership of same, and that they are entitled to have their title to same quieted against each of the Defendants in this action.

IV.

That at the time the Defendants Rees and wife purchased the property described in Paragraph I of this Second Cause of Action from Cora J. Skirving, formerly Nessly, neither of the Defendants herein knew that the improvements described in Paragraph III of this Second Cause of Action were upon the property of the Defendant, Cora J. Skirving, formerly Nessly, and that said improvements were no part of the consideration of said sale.

V.

That Plaintiffs have been wrongfully denied the use and income from said property since March 1, 1944, the fair rental value thereof being \$20.00 per month, or a total of seven (7) months to date, or the sum of One Hundred Forty (\$140.00) Dollars.

VI.

That Plaintiffs' occupancy, use and possession of the aforesaid North 65 feet of the property of the Defendants described in Paragraph I of Plaintiffs' Second Cause of Action arose from the establishment of a boundary line between Plaintiffs' and Defendants' property in 1929, at which time it was understood and agreed between Plaintiffs and the

Bankrupts' Exhibit No. 1—(Continued)

Defendant Cora J. Skirving, formerly Nessly, that the property of the Plaintiffs described in Plaintiffs' First Cause of Action as Tax Lot 4, included the North 65 feet of Defendants' property.

That at the time Defendants Rees and wife purchased said property from the other Defendant, Cora J. Skirving, formerly Nessly, said Defendants laid no claim to the North 65 feet thereof; but at all times believed that said sixty-five feet and the improvements thereon were a part of Tax Lot 4 acquired by them purportedly by County Treasurer's Deed on January 20, 1944.

Wherefore, Plaintiffs pray as follows:

I. That, as to Plaintiffs' First Cause of Action, the County Treasurer's deed dated January 20th, 1944, issued to the Defendants herein, be set aside, cancelled and held for naught; that the Defendants Rees and wife be required to deliver up to the Plaintiffs the property purportedly sold to them by the County Treasurer for King County, upon reimbursement to them by Plaintiffs for their expenditures in acquiring said property, the sum to be fixed by the Court and ordered paid out of the money deposited in the registry of the Court; that Plaintiffs be restored to full possession and ownership of said property, free of any right, title or interest of the Defendants, or either of them; that the Plaintiffs' title to said property be quieted as against any claim of the Defendants therein; that Defendants Clarence A. Rees and Evelyn E. Rees, his wife, be required to reimburse Plaintiffs for

Bankrupts' Exhibit No. 1—(Continued)
all loss of rentals during the period Plaintiffs have been kept out of possession of their property, and that Plaintiffs do have judgment therefor.

II. That, as to Plaintiff's Second Cause of Action, that the right, title and interest of Plaintiffs be quieted as against the Defendant, Cora J. Skirving, formerly Cora J. Nessly, and against the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, and each of them, to the North 65 feet of the Southwest Quarter of the Northeast Quarter, lying Southeasterly of the Northern Pacific Railway Right of Way and Westerly of Jenkins Creek, Section 2, Township 21 North, Range 5 East W. M., King County, Washington, said property being the North 65 feet of the property described in Paragraph I of Plaintiffs' Second Cause of Action, together with all improvements thereon.

III. That Plaintiffs be granted such other and further relief as to the Court may seem right and proper; and that they be granted their costs and disbursements to be taxed.

/s/ **LADY WILLIE FORBUS,**
Attorneys for Plaintiffs.

State of Washington,
County of King—ss.

Lady Willie Forbus, being first duly sworn, upon oath deposes and says:

That she is the attorney of record for the Plaintiffs in the above entitled action; that she has read the foregoing complaint, as amended, knows the

Bankrupts' Exhibit No. 1—(Continued)
contents thereof, and believes the same to be true;
and that she makes this verification on behalf of
the Plaintiffs for the reason that they are absent
and are unable to be present to make the same.

/s/ LADY WILLIE FORBUS.

Sworn to and subscribed before me on this Sep-
tember 6th, 1944.

/s/ PATRICIA SADLER,
Notary Public, in and for the State of Washing-
ton, residing in Seattle.

[Endorsed]: Filed Sept. 6, 1944.

In the Superior Court of the State of Washington
for King County

No. 352943

SOREN N. JENSEN and ANNA JENSEN, hus-
band and wife,

Plaintiffs,

vs.

CLARENCE A. REES and EVELYN E. REES,
his wife, and CORA J. NESSLY, now CORA
J. SKIRVING,

Defendants.

AMENDED ANSWER OF
DEFENDANTS REES

Come now the defendants, Clarence A. Rees and
Evelyn E. Rees, his wife, and answering the

Bankrupts' Exhibit No. 1—(Continued)
amended complaint of the plaintiffs, admit, deny
and allege as follows:

I.

Answering Paragraph I thereof, defendants admit the same.

II.

Answering Paragraph II and III thereof, defendants having no knowledge or information sufficient to form a belief as to the truth or falsity thereof, therefore deny the same.

III.

Admit and affirmatively allege that the property described in Paragraph IV of said amended complaint was segregated into tax lots 4 and 46 in the year 1928.

IV.

Answering the first paragraph of Paragraph V thereof, defendants having no knowledge or information sufficient to form a belief as to the truth or falsity thereof, therefore deny the same. Deny the second paragraph of said Paragraph V.

V.

Answering Paragraph VI thereof, defendants having no knowledge or information sufficient to form a belief as to the truth or falsity thereof, therefore deny the same.

Bankrupts' Exhibit No. 1—(Continued)

VI.

Answering Paragraph VII thereof, defendants admit that the general taxes on tax lot 4 were unpaid for the years 1924 through 1927, and following, and that the property was foreclosed and a tax deed issued to King County in April of 1932, but deny that plaintiffs had no knowledge of such facts until just prior to the institution of this action.

VII.

Answering Paragraph VIII thereof, defendants deny each and every allegation made and therein contained and particularly that the plaintiffs had no knowledge of the foreclosure.

VIII.

Deny Paragraph IX thereof.

IX.

Admit Paragraph X thereof.

X.

Admit the first paragraph of Paragraph XI thereof and deny the second paragraph in said Paragraph XI contained.

XI.

Admit the first paragraph of Paragraph XII and deny the second paragraph in said Paragraph XII contained.

Bankrupts' Exhibit No. 1—(Continued)

XII.

Answering Paragraph XIII thereof, admit that they now occupy and have occupied said property since acquiring the property from King County, but deny each and every other allegation in said paragraph contained.

XIII.

Answering Paragraph XIV thereof, admit that plaintiffs have offered to pay into the registry of this court, in the complaint first served herein, the sum of \$100, but deny each and every other allegation in said Paragraph XIV contained.

XIV.

Deny Paragraph XV thereof.

Answering further by way of affirmative defense, defendants Rees allege:

I.

That the defendant, Clarence Rees, formerly operated a green house and for some time past has endeavored to find a suitable location for the re-establishment of this business after the war. That in attempting to find a suitable location, he inspected a large area in the vicinity of Lake Meridian and found what he considered a suitable location for his proposed business near Jenkins Creek where it crosses the James B. Kinne road about four miles out of Kent. He inquired in the vicinity

Bankrupts' Exhibit No. 1—(Continued)

concerning the ownership of this property. The property appeared to be a large tract which had been used in times past to pasture cattle. A portion of it had not yet been cleared and the tract was lower than the road bed and was green, either due to springs on the property or to percolating waters; that there was a makeshift house and some sheds on the property.

II.

That the defendant Clarence Rees learned that title to a twenty-two (22) acre portion of the tract was in the name of Cora Skirving and that King County owned a small triangular portion of approximately 1.7 acres and that the portion owned by King County was for sale. That Schedule "A" hereto attached and by this reference made a part hereof is a rough sketch of the two tracts according to the plat in the assessor's office.

III.

That defendant Clarence Rees again viewed the property and as far as he could discern, the sheds and place upon which the people were living were located mostly on the property owned by Mrs. Skirving, with a portion of said structures projecting over onto the tract owned by King County. That thereafter he wrote to Cora Skirving asking if she would sell her property and inquiring as to what terms. He later received an answer stating the terms and a sale was consummated, the property being described by a metes and bounds description and including appurtenances.

Bankrupts' Exhibit No. 1—(Continued)

IV.

That at approximately the same time the sale with Cora Skirving was consummated, a sale was also consummated with King County for the purchase of the triangular tract which has been referred to in plaintiff's amended complaint as tax lot 4.

That upon taking possession of the property, defendants found that the improvements consisted of a four-room house with an annex, sheds and a ship's refrigeration compartment which resembled a box car. That the ship's refrigeration compartment was suitable as a storage room only. That while the house had plumbing facilities, they were not in a usable condition, the pipes being clogged with filth and there was no outlet for waste materials. That the ceiling in the main room of the house had broken loose and was falling in. That the floors were warped from exposure to the elements and a lack of a proper foundation. Likewise, that the walls were out of plumb and were discolored and stained from exposure.

V.

That immediately upon taking possession, defendants Rees spent time and money making the place sanitary and livable. That they sanded the floors, temporarily tacked up the ceiling of the rooms, put a pump into operation and cleaned out the pipes and pumping system.

Bankrupts' Exhibit No. 1—(Continued)

VI.

That Soren Jensen then claimed he was the owner, demanded \$1,200 from the defendants and threatened them with extended litigation should the defendants Rees fail to pay his claim.

VII.

That so far as defendants were able to ascertain, Cora Skirving had owned the 22-acre tract since about 1920. That from the time Cora Skirving acquired the property until about 1932, she leased the property to T. C. George, a land owner in that vicinity, for pasturing his cows. That to prevent cattle from wandering onto the public road, a two-wire fence was strung along the right-of-way of the County Road from the junction of the railroad to Jenkins Creek.

VIII.

That in or about the year 1932, Cora Skirving sold the property under a real estate contract to one John Hamilton, also known as "Doc" Hamilton, a negro. That this contract was not recorded. That "Doc" Hamilton used part of the Skirving property to pasture cattle and other neighbors also pastured cattle there during the time "Doc" Hamilton was in possession and thereafter to the present time, using the entire cleared area of the Cora Skirving property and the King County property.

Bankrupts' Exhibit No. 1—(Continued)

That at no time was there a dividing fence of any nature whatsoever between the Cora Skirving property and tax lot 4.

IX.

That "Doc" Hamilton in about the year 1936 or 1937 purchased a ship's refrigeration compartment at a ship's salvage sale in Seattle and had the ship's refrigeration compartment moved onto the Cora Skirving property. That he erected a building for roadhouse purposes on the Cora Skirving property. That thereafter in 1938 he abandoned the place and a foreclosure action was begun for material and labor liens for plumbing fixtures put in said roadhouse. That Cora Skirving was made a party defendant to the foreclosure action and a stipulation was entered into between Cora Skirving and the plaintiffs in the foreclosure action in 1938 that the buildings should be sold as personal property and that there would be no cloud on title or claim against the real property. That Soren Jensen bid the buildings in at the sheriff's sale, following the foreclosure action, in December of 1938.

X.

That thereafter Soren Jensen obtained Cora Skirving's permission to move the buildings off the cement foundation on the Skirving property, but after receiving said permission, he moved the buildings a short distance only and then abandoned the task. That the buildings were abandoned and

Bankrupts' Exhibit No. 1—(Continued)

deserted for a period of time. That cattle were pastured by the neighbors on the Skirving and King County property after said foreclosure sale; that at no time was Soren Jensen in continuous, open, notorious or exclusive possession of any of the Skirving property.

XI

That the plaintiff Soren Jensen knew of the segregation and foreclosure of tax lot 4 by King County as shown by his discussion of tax statements received with T. C. George, a neighbor, in or about 1931; and the discussions of the unpaid taxes on all portions of the property involved in the foreclosure case of the National City Bank of Seattle vs. Washington Irrigation and Land Company (which is also referred to in plaintiffs' complaint), said discussions being with Burton J. Wheelon, attorney for the National City Bank of Seattle in said foreclosure action, in the course of said litigation in attempting to work out a settlement of the action in the year 1932.

Wherefore having fully answered, defendants Rees pray that plaintiffs' amended complaint be dismissed and for their costs and disbursements herein to be taxed against the plaintiffs.

/s/ DAVID J. WILLIAMS and
MARY E. BURRUS

Attorneys for Defendants
Rees.

State of Washington,
County of King—ss.

Clarence A. Rees, being first duly sworn on oath, deposes and says: That he is one of the defendants in the above entitled action; that he makes this verification on behalf of himself and his wife, Evelyn E. Rees, and is authorized so to do; that he has read the foregoing Amended Answer, knows the contents thereof and believes the same to be true.

CLARENCE A. REES.

Subscribed and sworn to before me this 31 day of October, 1944.

/s/ MARRY E. BURRUS,
Notary Public in and for the State of Washington,
residing at Seattle.

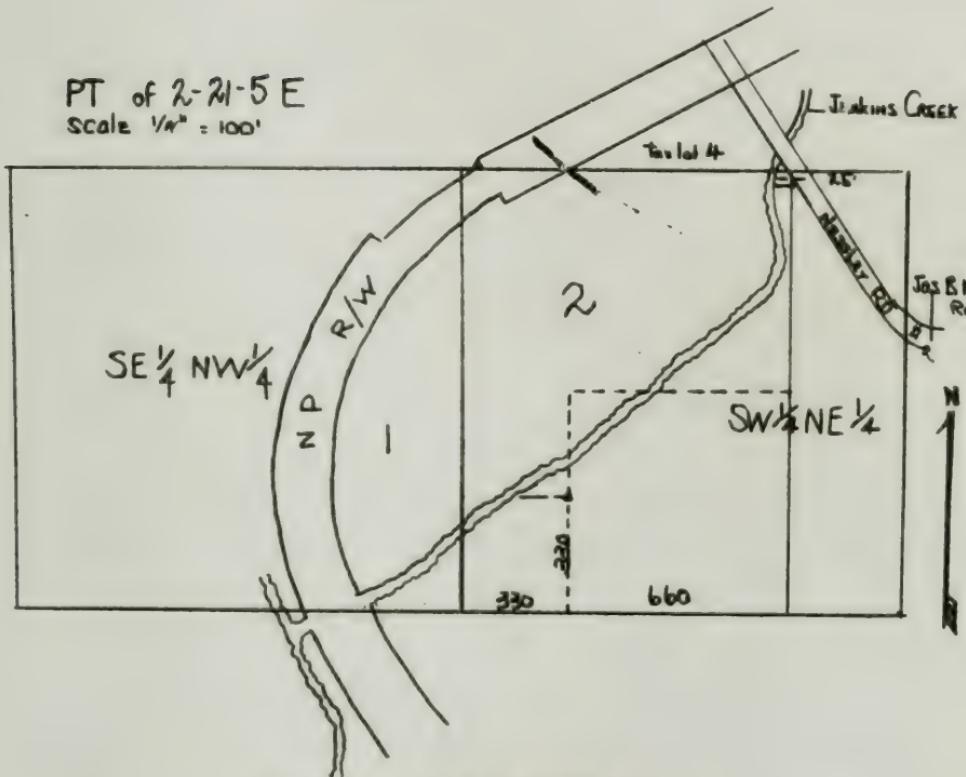
Copy Received: Date, Nov. 3, 1944. Firm,
Lady Willie Forbus. By D. B.

SCHEDULE "A"

J.C. SWIRVING PROPERTY SOLD TO DEFENDANTS REEDS

and

F.Y. LOT "4"

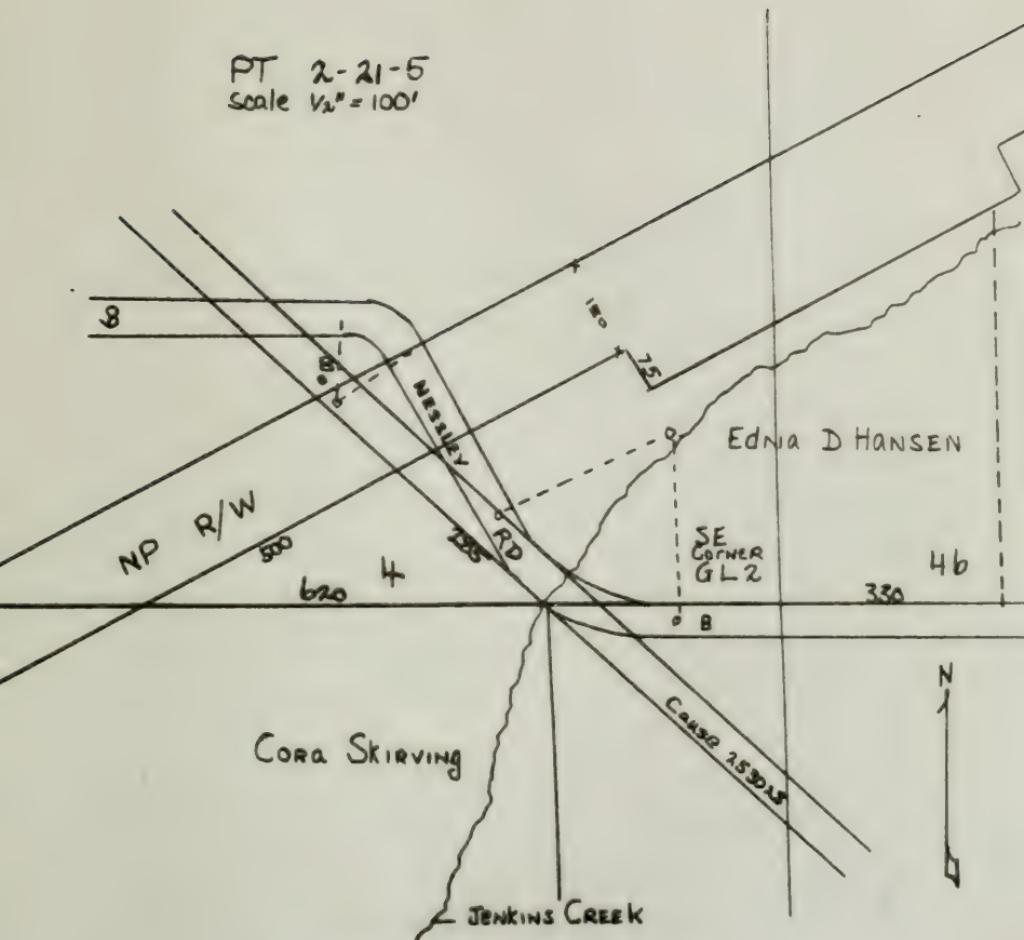


DESCRIPTIO OF SWIRVING PROPERTY SOLD

That portion of the Southeast quarter of the Northwest quarter of Section Two (2), Township Twenty-One (21) North, Range 5, E.W.M., lying east of the Northern Pacific Railway right of way, AND the west 990 feet of the southwest quarter of the Northeast quarter of said section, LESS the Northern Pacific Railway right of way; LESS the south 660 feet of the east 660 feet; LESS portion of the north 660 feet lying easterly of Jenkins Creek, AND LESS portion of the South 330 feet of the west 330 feet lying easterly of Jenkins Creek; Together WITH a right of way for road over that portion of the north 25 feet of the southwest quarter of the northeast quarter lying between Jenkins Creek and Soos Creek, Berrydale road, EXCEPT roads; King County, Washington

SCHEDULE "A"

TAX LOT "4"

PT 2-21-5
Scale $\frac{1}{2}$ " = 100'

All of Government Lot 2 lying Southeast of Railroad and Westerly of Jas. B. Kinne Road (4), Section 2, Township 21 North, Range 5 East, W. M., situated in King County, Washington.

8/32 [RE: closed] Filed Nov 2 1955.

**BANKRUPT'S EXHIBIT No. 2
REAL ESTATE CONTRACT**

It Is Hereby Agreed by and between Cora J. Skirving, formerly Cora J. Nessly (a widow), the vendor, and Clarence A. Rees and Evelyn E. Rees, the purchasers, that the said vendor will sell to said purchasers, their heirs or assigns, and that the said purchasers will purchase the following described lot, tract, or parcel of land situated in King County, State of Washington, to-wit:

That portion of the southeast quarter of the northwest quarter of Section Two (2), Township Twenty-one (21) North, Range Five (5), E.W.M., lying east of the Northern Pacific Railway right of way; and the west 990 feet of the southwest quarter of the northeast quarter of said section, less the Northern Pacific Railway right of way; less the south 660 feet of the east 660 feet; less portion of the north 660 feet lying easterly of Jenkins Creek, and less portion of the south 330 feet of the west 330 feet lying easterly of Jenkins Creek together with a right of way for road over that portion of the north 25 feet of the southwest quarter of the northeast quarter lying between Jenkins Creek and Soos Creek Berrydale road; except roads; with the appurtenances thereto belonging, on the following terms:

1. The purchase price of said land is Twenty-one Hundred and No/100 Dollars (\$2100.00), of which the sum of Five Hundred and No/100 Dollars (\$500.00) has this day been paid, the receipt

whereof is hereby acknowledged by said vendor and the further sum of Sixteen Hundred and No/100 Dollars (\$1,600.00) to be paid at address furnished as follows: The sum of \$200.00 or more on the seventh day of January, 1945, and the sum of Two Hundred Dollars or more each succeeding January seventh with interest on all deferred payments from date hereof at the rate of five per cent per annum, to be paid annually until the full payment thereof.

2. Said purchasers agree to pay all taxes, assessments and impositions levied or assessed against said property subsequent to the date hereof, at the time the same shall become due and payable; also to keep all buildings thereon insured for a sum equal to the deferred payments above specified, in some insurance company satisfactory to said vendor, with loss, if any, payable to said vendor or her assigns as their interest may appear.

3. It is further agreed that no extension of time of payment or waiver of default in the payment of any instalment of principal or interest due under this contract shall affect the right of said vendor to require prompt payment of any subsequent instalments of principal or interest, or to declare a forfeiture for non-payment thereof.

4. Said purchasers agree to execute, acknowledge and deliver at any time on demand of vendor a mortgage for balance unpaid on this contract, payable in instalments as herein specified, and to assign insurance as security for payment thereof in a sum equal to the face of such mortgage.

5. Said land shall be conveyed by a good and sufficient Title Insurance and deed to said purchasers, when said purchase price shall be fully paid, or upon demand of vendor for a mortgage covering the unpaid portion of purchase price.

6. Time is of the essence of this contract, and in case of failure of the said purchasers to make either of the payments or perform any of the covenants on their part, this contract shall be forfeited and determined at the election of the said vendor; and the said purchasers shall forfeit all payments made by them on this contract and all rights acquired hereunder, and such payments shall be retained by the said vendor as liquidated damages, and she shall have the right to re-enter and take possession of said land and premises and every part thereof.

It is hereby agreed that if full payment is made in one year from this date that (\$1900.00) Nineteen Hundred and no/100 Dollars will be accepted as full payment.

Executed in duplicate this 13 day of January, 1944.

[Seal] CORA J. SKIRVING

[Seal] EVELYN E. REES

[Seal] CLARENCE A. REES

[Letterhead of M. L. Longfellow]

February 26, 1944.

Mr. S. N. Jensen, and
Anna Jensen,
425 Harrison Street
Kent, Washington

Mr. Emmett D. Gordon and wife
Renton, Washington

Dear Sirs:

I am writing you on behalf of Clarence A. Rees and wife, concerning Real Estate located in King County, Washington, described as follows, to-wit:

All of Government Lot 2 Lying Southeast of Railroad and Westerly of Jas. B. Kinne Road (4), Section 2, Township 21 North, Range 5 East, W. M.

This property was acquired by deed by Mr. and Mrs. Rees under date of January 20th, 1944, and they have been entitled to the possession thereof ever since said date.

I understand that Mr. Emmett D. Gordon and wife are now residing on this property, or a part of the same, claiming the right to so occupy the same by authority of Mr. and Mrs. Jensen, but there is no legal basis for said occupancy by any of the parties hereinabove mentioned, and you are hereby notified and required to vacate said property immediately upon receipt of this notice.

There is a dwelling house located in part, possibly, upon this property, but Mr. Rees has purchased other real estate joining this, and consequently is entitled to the dwelling house regardless of whether the same is located upon the real estate hereinabove described, or upon the other tract of real estate which has been purchased by Mr. Rees.

Yours very truly,

Mll:m /s/ M. L. LONGFELLOW.

[Endorsed]: Filed April 20, 1945.

BANKRUPTS' EXHIBIT No. 3

In the Superior Court of the State of Washington
for King County

No. 352943

SOREN N. JENSEN and ANNA JENSEN,
husband and wife,

Plaintiffs,

vs.

CLARENCE A. REES and EVELYN E. REES,
his wife, and CORA J. NESSLY, now CORA
J. SKIRVING,

Defendants.

FINDINGS OF FACT AND CONCLUSIONS
OF LAW

This Cause coming on regularly for trial on April 19, 1945, before the above entitled Court, the Honorable J. T. Ronald presiding, upon the

Bankrupts' Exhibit No. 3—(Continued)

Amended Complaint of Plaintiffs, impleading in equity, and the Amended Answer of Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, and the Answer of Cora J. Skirving, another Defendant; whereupon said cause proceeded to trial; and the Court having heard the testimony and evidence of Plaintiffs and their witnesses, Plaintiffs rested; and thereupon the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, introduced testimony and evidence in their behalf and rested; and thereupon the Defendant, Cora J. Skirving gave testimony in her own behalf and rested; and the Court having heard the testimony and evidence, and having heard the arguments of respective counsel, the Plaintiffs appearing by and through their attorney of record, Lady Willie Forbus, and the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, appearing by and through their attorneys of record, David J. Williams and Mary E. Burrus, and the defendant, Cora J. Skirving, appearing per se; and the Court having fully considered the law and the evidence in said cause,

Now, Therefore, the Court Hereby Makes the following

Findings of Fact

I.

That plaintiffs and Defendants are now and during the times herein mentioned have been residents of King County, Washington.

Bankrupts' Exhibit No. 3—(Continued)

II.

That on or about June 4, 1929, Plaintiffs purchased on real estate contract from the Seattle Development Company of Seattle, Washington, the following described property:

That portion of Government Lot No. 2, Section 2, Township 21 North, Range 5 East W.M., lying Southeasterly of the Northern Pacific Railway Company's right of way, and the West 330 feet of that portion of Government Lot No. 1, of said Section 2, lying southerly of said right of way, all in King County, Washington.

which said contract was recorded June 27, 1929, in Vol. 1435 of Deeds, page 409, under Author's File No. 2545354, records of the office of County Auditor of King County, Washington.

III.

That at the time Plaintiffs purchased the aforesaid property the National City Bank of Seattle, Washington, held a first real estate mortgage upon the same; and that said mortgage was thereafter foreclosed in Cause No. 236197 and a decree of foreclosure was entered therein in the Superior Court of King County, Washington, in due course.

That thereafter on or about December 19, 1931, said property was offered for sale at public auction in satisfaction of the judgment, whereupon Plaintiffs became the best and highest bidder for same,

Bankrupts' Exhibit No. 3—(Continued)
and on January 22, 1932, the Superior Court of King County ordered the sale confirmed, whereupon the Sheriff of King County issued a Sheriff's deed to Plaintiffs covering said property, which deed was recorded on December 20, 1932, in Volume 1518 of Deeds, page 201, records of the King County Auditor, under Auditor's file No. 2744699.

IV.

That in the year 1928 the aforesaid property was segregated by the Assessor's office of King County as follows:

- (a) That portion of said Government Lot 2, lying southeasterly of the Northern Pacific Railroad Company right of way and Westerly of the James B. Kinne Road, Section 2, Township 21 North, Range 5 EWM, situated in King County, Washington, being known as Tax Lot 4;
- (b) That portion of said Government Lot 2, lying southeasterly of the Northern Pacific Railroad Company right of way and Easterly of the James B. Kinne Road, together with the West 330 feet of Government Lot 1, lying southerly of said railroad right of way, situated in King County, Washington, being known as Tax Lot No. 46.

V.

That both the real estate contract issued in 1929 and the Sheriff's Deed issued in 1932, to Plaintiffs,

Bankrupts' Exhibit No. 3—(Continued) contained the legal description set out in Paragraph II as one single tract.

That at no time during the times hereinbefore or hereinafter mentioned did the Plaintiffs actually learn of the segregation of their property into Tax lots 4 and 46; nor did they actually learn of said segregation until just prior to the institution of this action, but as a matter of fact the segregation had been made of record by the County Assessor in 1927.

VI.

That during the year 1929, after the Plaintiffs purchased the aforesaid property, Edna D. Hanson purchased the vendor's equity in Subdivision (b) above, or Tax Lot 46, from the Seattle Development Company, subject to Plaintiffs' contract of sale.

VII

That the general taxes on tax lot 46, being subdivision (b) above, were paid December 31, 1929, by said Edna D. Hanson or her agents and thereafter by the Plaintiffs in this action.

That the general taxes on Tax Lot No. 4, being subdivision (a) above, were unpaid for the years 1924 to 1927, inclusive, and on June 25, 1930, King County foreclosed its certificate of delinquency for said general taxes in Cause No. 232197, Superior Court of King County, Washington, which action proceeded to judgment and a tax deed covering

Bankrupts' Exhibit No. 3—(Continued)
Tax Lot 4 was issued to said King County on April 21, 1932, as shown by King County Auditor's File No. 2718790, records of King County.

VIII.

That during the month of March, 1930, as pleaded, but on May 10, Plaintiff's went to the King County Treasurer's Office at the Courthouse in Seattle, Washington, and requested a tax statement of all their general taxes due to date, and offered to pay the same, having cash in his hands so to do. That the plaintiff, Soren N. Jensen, contacted a Deputy on duty behind the counter, who took him into a room and after examining a book informed him that the taxes had been paid on said lot and that there was then nothing due.

That Plaintiffs being ignorant of any segregation and without actual knowledge that taxes then due on tax Lot 4 (Subdivision (a) herein) had not been paid, and relying upon the statements made to him by the Deputy, left the office without paying the same.

That the Plaintiffs continued to pay from year to year the taxes shown upon tax statements issued out of the office of the County Treasurer without further checking or further examining said statements, at all times believing that the property described therein was all of the property of the parties purchased on contract.

Bankrupts' Exhibit No. 3—(Continued)

IX.

That the property consists of vacant, pasture land of approximately 1.5 acres.

X.

That on or about January 20, 1944, King County conveyed to the Defendants Rees and wife herein under Tax Deed from the Treasurer of King County, recorded January 24, 1944, in Volume 2196 of Deeds, page 528, under Auditor's File No. 3361972, records of said County, the property acquired by foreclosure on April 21st, 1932, as follows:

(a) That portion of said Government Lot 2, lying Southeasterly of the Northern Pacific Railroad Right of Way and Westerly of the James B. Kinne Road, Section 2, Township 21 North, Range 5 EWN, situated in King County, Washington, being known as Tax Lot 4, said Defendants being Clarence A. Rees and Evelyn E. Rees, his wife.

That said sale was made without the actual knowledge of Plaintiffs, and that they did not actually learn of any of the transactions connected with the acquisition of said property or its sale to the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, until on or about the 14th day of January, 1944, when the Defendant, Clarence A. Rees, demanded immediate possession of said property from the plaintiffs and their tenants.

Bankrupts' Exhibit No. 3—(Continued)

XI.

That the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, paid King County the sum of Fifty (\$50.00) Dollars for said property, together with the costs of sale thereof, amounting to approximately \$9.00.

~~That at the time of the purchase of said property the Defendants Rees and wife, knew the value of said property was greatly in excess of the amount paid, and also knew that Plaintiffs were ignorant of the pending proceedings for the sale of said property by the County Treasurer.~~

XII.

That at the time of the issuance of the deed to Defendants, Rees and wife, the Plaintiffs had tenants upon said property, and that Defendants Rees and wife demanded that said tenants immediately leave the premises and deliver up physical possession to them; and that immediately thereafter the Defendants Rees and wife took possession of the premises and have kept same up to the present time, over the objections of Plaintiffs.

XIII.

That Plaintiffs have tendered here into the registry of this Court the sum of One Hundred (\$100.00) Dollars, to repay Defendants Rees and wife for all sums expended by them in payment for the land and all other necessary expenses incurred by them in connection therewith, and offer to pay any further sums unforeseen at this time for the purpose of reimbursing Defendants Rees and wife in full for all necessary sums by them paid.

Bankrupts' Exhibit No. 3—(Continued)

XIV.

That at the time Plaintiffs acquired the aforesaid property on June 14, 1929, and later by Sheriff's deed on December 20, 1932, the Defendant, Cora J. Skirving, then Cora J. Nessly, owned the following described land adjoining Plaintiff's above described Tax Lot 4, along the south boundary line thereof, to-wit:

That portion of the Southeast quarter of the Northwest quarter of Section 2, Township 21, North, Range 5 East WM, lying East of the Northern Pacific Railway Right of Way; and the West 990 feet of the Southwest Quarter of the Northeast Quarter of said Section, less the Northern Pacific Railway Right of Way; and less the South 660 feet of the East 660 feet; less portion of the North 660 feet lying Easterly of Jenkins Creek; and less portion of the South 330 feet of the West 330 feet lying Easterly of Jenkins Creek, together with a right of way for road over that portion of the North 25 feet of the Southwest Quarter of the Northeast Quarter lying between Jenkins Creek and Soos Creek-Berrydale Road; except roads, situated in King County, Washington.

XV.

That on or about January 13, 1944, the Defendant, Cora J. Skirving, formerly Cora J. Nessly, sold the aforesaid property on real estate contract to

Bankrupts' Exhibit No. 3—(Continued)
the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, which said contract was recorded in the office of the County Auditor of King County, Washington, on April 19, 1944, in Volume 2218 of Deeds, at page 397, under Auditor's File No. 3378923, records of said County.

That said Defendant, Cora J. Skirving, formerly Nessly, delivered possession of said property to the Defendants Rees and wife, who immediately thereafter took possession of same and are in possession at the present time: and that since the institution of this action said Defendants have paid the full balance due upon said contract, and have received a warranty deed from Cora J. Skirving covering said property.

XVI.

That in 1932, one Doc Hamilton purchased the aforesaid property on real estate contract, and in 1932 erected a house, sheds, barn and removed a refrigerator car thereon; that thereafter certain labor liens were foreclosed thereon, and Cora J. Skirving was made a party defendant. That subsequently she entered into a stipulation in said action that the buildings be separated from the land and sold as personality, and the title to her land be free from any cloud thereby.

XVII.

That, in accordance with said stipulation, on or about May 9, 1938, said buildings were offered for sale at public auction by the Sheriff of King County

Bankrupts' Exhibit No. 3—(Continued)

and that Plaintiffs purchased the same. That thereafter Plaintiffs removed all of said buildings from the particular place where they were then standing onto the North 65 feet of the above described property, by mistake and inadvertance and under the mistaken belief that they owned said property as the south portion of Lot 4. That at said time it was the general belief of both Plaintiffs and the Defendant Skirving that the North 65 feet belonged to Tax Lot 4, and said Defendant agreed that said buildings might be permanently located at the place of removal under that belief.

That at no time would the Plaintiffs have continued in possession of or maintained said buildings upon the North 65 feet as aforesaid, and at no time would the Defendant Skirving have agreed that Plaintiffs should remain in possession of said North 65 feet, if they, or either of them, had known where the true boundary line between Tax Lot 4 and the Defendant Skirving's property actually existed.

That the houses, sheds, barns and each structure now upon said North 65 feet have been at all times considered as personality by the Plaintiffs and the Defendant Skirving; and that at the time of her sale of said property to the Defendants, Clarence A. Rees and wife, said structures were not included in the sale and no consideration was given for them, or either of them. That the Defendants Rees and wife never at any time believed they were purchasing said structures, or either of them, having been advised at the time of their purchase that the buildings were no part of the property purchased.

Bankrupts' Exhibit No. 3—(Continued)

XVIII.

That notwithstanding the facts hereinabove set out, the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, on or about January 20, 1944, took possession of all and every one of the structures hereinabove mentioned, moved into the house and ejected the Plaintiffs' tenants therefrom, and in all respects converted said property to their own uses; and denied the use or possession of same to Plaintiffs and their tenants; and continue to do so up to the present time, although the Plaintiffs collected rent thereon for January and February, 1944, and their tenants remained in possession of said houses during said period.

XIX.

That the fair market value of the house and other structures upon the North 65 feet of the Defendant Skirving's property so converted by the Defendants, Rees and wife, at the time of the conversion or about January 20, 1944, was \$1,000.00.

To each and every finding herein the Defendants Clarence A. Rees and Evelyn E. Rees, his wife, except, and their exceptions are hereby allowed.

Done in Open Court this 5th June, 1945.

J. T. RONALD,
Judge.

Bankrupts' Exhibit No. 3—(Continued)

And from the foregoing Findings of Fact, the Court makes the following

Conclusions of Law

I.

That the Plaintiffs have not established their right to have the Tax Deed to Tax Lot 4 set aside nor to have the title to said Tax Lot 4 quieted in them upon the ground of equitable frustration by clear, cogent and convincing evidence, as set out in the first cause of action of their complaint, as amended; and that said first cause of action should be dismissed.

II.

That the evidence does not establish that Plaintiffs have been in open, hostile, notorious and exclusive possession of the North 65 feet of the property of the Defendants, as set out in Plaintiffs' second cause of action; and that Plaintiffs are not entitled to said property upon the ground of acquisition by adverse possession; and that said second cause of action should be dismissed.

III.

That this is an equitable action, and the Court has the right to do equity between the parties, once it has acquired jurisdiction of the parties and the causes of action.

Bankrupts' Exhibit No. 3—(Continued)

IV.

That the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, have converted personal property belonging to the Plaintiffs, consisting of a house, shed, barn and other structures situated on the North 65 feet of the Defendants' property, which property was so located thereon by agreement of the Plaintiffs and Defendant Skirving, and was at all times considered as personal property in which the Defendant Skirving never at any time claimed an interest, and was not sold to the Defendants Rees and no consideration was paid by the Defendants Rees therefor.

That the Defendants Rees and wife have become unjustly and unlawfully enriched by their conversion of Plaintiffs' buildings in the amount of \$1,000.00, and Plaintiffs are entitled to judgment therefor.

V.

That the Plaintiffs are entitled to their Costs and disbursements herein expended against the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, and the community composed of them.

VI

That the Defendant, Cora J. Skirving, is entitled to have the above entitled action dismissed as to her; and she is entitled to her costs and disbursements expended in the sum of \$5.50 against the Plaintiffs.

Bankrupts' Exhibit No. 3—(Continued)

To each and every conclusion herein the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, except, and their exceptions are hereby allowed.

Done in Open Court this 5th June, 1945.

J. T. RONALD,

Judge.

BANKRUPTS' EXHIBIT No. 4

In the Superior Court of the State of Washington
for King County.

No. 352943

SOREN N. JENSEN and ANNA JENSEN,
husband and wife,

Plaintiffs,

vs.

CLARENCE A. REES and EVELYN E. REES,
his wife, and CORA J. NESSLY, now CORA
J. SKIRVING,

Defendants.

DECREE

This cause coming on regularly for trial on April 19, 1945, before the above entitled Court, the Honorable J. T. Ronald presiding, upon the Amended Complaint of the Plaintiffs, impleading in equity, and the Amended Answer of the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife; and

the Answer of Cora J. Skirving, another Defendant; the Plaintiffs appearing in person and by and through their attorneys of record, Lady Willie Forbus; and the Defendants Rees and wife appearing by and through their attorneys of record, David J. Williams and Mary E. Burrus; and the Defendant, Cora J. Skirving appearing per se; whereupon said cause proceeded to trial; and the Court having heard the testimony and evidence of Plaintiffs and their witnesses, Plaintiffs rested; and thereupon the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, introduced testimony and evidence in their behalf and rested; and thereupon the Defendant, Cora J. Skirving gave testimony in her own behalf and rested; and the Court having heard the testimony and evidence, and having heard the arguments of respective counsel; and the Court having fully considered the law and the evidence in said cause; and having heretofore made and entered its Findings of Fact and Conclusions of Law in writing and filed the same;

Now, Therefore, It Is Hereby Ordered, Adjudged and Decreed that the first cause of action of Plaintiffs' Complaint be and the same hereby is dismissed as to the Defendants, Clarence E. Rees and Evelyn E. Rees, his wife.

It Is Further Ordered, Adjudged and Decreed that the second cause of action of Plaintiffs' Complaint be and the same hereby is dismissed as to the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, and as to the defendant, Cora J. Skirving.

It Is Further Ordered, Adjudged and Decreed that the Plaintiffs do have and recover judgment against the Defendants, and the community composed of Clarence A. Rees and Evelyn E. Rees, his wife, in the sum of One Thousand (\$1,000.00) Dollars.

It Is Further Ordered, Adjudged and Decreed that the Plaintiffs do have and recover their costs and disbursements herein to be taxed against the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, and the community composed of them.

It Is Further Ordered, Adjudged and Decreed that the Defendant, Cora J. Skirving, do have and recover her costs and disbursements in the sum of \$5.50 against the Plaintiffs.

To all and each and every part of which the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, except, and their exceptions are hereby allowed.

Done in Open Court this June 5th, 1945.

J. T. RONALD,
Judge.

Presented by:

LADY WILLIE FORBUS,
Attorney for Plaintiffs.

Copy received this May 4, 1945.

COLVIN & WILLIAMS,
Attorneys for Defendants
Rees and Wife.

By JOYCE HOLMGREN,
Attorney Per se.

[Endorsed]: No. 11830. United States Circuit Court of Appeals for the Ninth Circuit. Clarence A. Rees and Evelyn E. Rees, bankrupts, Appellants, vs. Soren N. Jensen and Anna Jensen, Appellees. Transcript of Record upon appeal from the District Court of the United States for the Western District of Washington, Northern Division.

Filed January 12, 1948.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

In the United States Circuit Court of Appeals
for the Ninth Circuit

No. 11830

In the Matter of
CLARANCE A. REES and EVELYN E. REES,
a marital community,

Bankrupts, Appellants,

vs.

SOREN N. JENSEN and ANNA JENSEN,
his wife, Creditors, Respondents.

STATEMENT OF POINTS

The decision of the District Court approving the Referee's decision was founded upon a misconception of the law. While the District Judge indicated that he perceived that the facts showed no more

than a technical conversion, he erred in failing to distinguish between the law here applicable and the law properly applicable only to those conversions arising out of aggravated circumstances. He further erred in believing himself bound to uphold the Referee's decision, when the decision for the reasons which appear below, was not supported by the records in the cause.

1. The decision of the Referee in Baukrupctey showed a complete misunderstanding of the facts in the case and was arbitrary and erroneous in both fact and law.
2. The Referee found facts which the State Superior Court had expressly declined to find and which putative facts were without support in the record.
3. The Referee improperly drew certain inferences from the failure of the Bankrupt, Clarence A. Rees, to testify at the hearing before the Referee.
4. The Referee ignored the record as to the location upon the land of the structures technically converted by the Bankrupts, Rees, thus evidencing a failure to comprehend the issues in the State Court proceeding and the nature of the resultant judgment debt.
5. The Bankrupts in the proceedings before the Referee were not given the benefit of the presumptions existing in their favor upon the issue and were thereby prejudiced.

The prime factor in this appeal is that the record does not show such wilful and malicious injury to the property of another as to exempt the judgment debt of the respondents Jensen from the discharge in bankruptcy, and it was error both in law and in fact to have so excepted such judgment debt.

CALVIN & WILLIAMS,
Attorneys for Bankrupts,
Appellants.

Copy received Jan. 22, 1948.

/s/ LADY WILLIE FORBUS,
Attorney for Creditors,
Jensen et al.

[Endorsed]: Filed Jan. 23, 1948.

IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

CLARANCE A. REES and EVELYN E. REES, bankrupts,
Appellants,

vs.

SOREN N. JENSEN and ANNA JENSEN, *Appellees.*

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WASHINGTON,
NORTHERN DIVISION

BRIEF OF APPELLANTS

COLVIN & WILLIAMS,
Attorneys for Appellants.

DAVID J. WILLIAMS,
MARY E. BURRUS,
of Counsel.

Central Building,
Seattle 4, Washington.

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IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

CLARANCE A. REES and EVELYN E. REES, bankrupts,
Appellants,

vs.

SOREN N. JENSEN and ANNA JENSEN, *Appellees.*

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WASHINGTON,
NORTHERN DIVISION

BRIEF OF APPELLANTS

COLVIN & WILLIAMS,
Attorneys for Appellants.

DAVID J. WILLIAMS,
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INDEX

| | Page |
|---|------|
| Jurisdiction | 1 |
| Statement of the Case..... | 2 |
| Specification of Errors | 10 |
| Statement of Points | 11 |
| Argument | 13 |
| I. Appellees should have shown those aggravated features in appellants' conduct which are a necessary constituent of a wilful and malicious injury to property in order to have estopped appellants from obtaining the benefit of their discharge in bankruptcy | 14 |
| A. Not every conversion is a wilful and malicious injury to property within Section 17(a)(2) of the Bankruptcy Act (11 U.S.C. §35(a)(2)) .. | 15 |
| B. Wilfulness and malice are present only where there is a wanton disregard of the rights of others | 16 |
| C. The burden of proof of wilfulness and malice was upon appellees | 22 |
| II. Appellants did not act in wanton disregard of appellees' rights; therefore, appellants did not wilfully and maliciously injure appellees' property | 23 |
| III. The decision of the Referee in Bankruptcy was based upon facts not of record..... | 28 |
| A. In the face of the express refusal of the Superior Court to so find, the Referee found that appellants knew that the value of Tax Lot was greatly in excess of the amount paid therefor | 29 |
| B. The Referees' finding that the structures herein were known to appellants to be the personal property of appellees is without basis in the record | 29 |
| C. The Referee ignored the record as to the location upon the land of the structures converted by appellants | 30 |

| | Page |
|---|------|
| IV. The Referee, by drawing an inference unfavorable to appellants from their failure to take the witness stand, erroneously shifted the burden of proof | 32 |
| A. After indicating that he was unable to perceive any evidence of wanton misconduct by appellants, the District Court erroneously sustained the Referee's decision that appellants had acted wilfully and maliciously..... | 35 |
| B. The District Court accorded excessive weight to the Referee's findings of fact..... | 36 |
| Conclusion | 38 |

INDEX OF CASES

| | |
|---|--------------------|
| <i>Blauweiss, In re</i> (City Ct. of N.Y. Queens County) 23 N.Y. Supp. (2d) 907 (1940) | 21 |
| <i>Bowen, In re</i> (D.C. E.D. Pa.) 58 F. Supp. 286, 294 (1944) affirmed (C.C.A. 3) 151 F.(2d) 690 (1945) | 37 |
| <i>Brown v. Garey</i> , 267 N.Y. 167, 196 N.E. 12 (1935) | 15, 18, 22 |
| <i>Buzas, Matter of</i> (D.C. N.D.Cal) 58 F. Supp. 717 (1944) | 21 |
| <i>W. F. Corvin & Co. v. United States</i> (C.C.A. 6) 181 Fed. 296, 104 C.C.A. 270 (1910) | 33 |
| <i>Davis v. Aetna Acceptance Co.</i> , 293 U.S. 328, 332, 55 Sup. Ct. 151 (1934) | 15, 16, 17, 19, 22 |
| <i>Emigh v. Lohnes</i> , 21 Wn. (2d) 913, 153 P.(2d) 869 (1944) | 20 |
| <i>Frangos v. Frangos</i> (Superior Ct. Pa.) 157 Pa. Super. 87, 31 A.(2d) 416 (1945) | 21 |
| <i>Frech, In re</i> (D.C. N.J.) 109 Fed. 620 (1901) | 20 |
| <i>Goldstein, Matter of</i> (D.C. S.D.N.Y.) 30 F. Supp. 443 (1939) | 21 |
| <i>Green, In re</i> (C.C.A. 7) 87 F.(2d) 951 (1937) | 20 |
| <i>Gumbinsky, In re</i> (D.C. W.D.N.Y.) 8 F. Supp. 601 (1934) | 21 |
| <i>Hercules Gasoline Co., In re</i> (C.C.A. 9) 76 F.(2d) 677 (1935) | 38 |
| <i>Kreitlein v. Ferger</i> , 238 U.S. 21, 26, 35 Sup. Ct. 685 (1915) | 22 |

TABLE OF CASES

v

Page

| | Page |
|---|----------------|
| <i>La Porte, In re</i> (D.C. W.D.N.Y.) 54 F. Supp. 911 (1943) | 20 |
| <i>Levitian, In re</i> (D.C. N.J.) 224 Fed. 241 (1915)..... | 15, 20, 23 |
| <i>Massachusetts Bonding Co. v. Lineberry</i> , 320 Mass. 410, 70 N.E.(2d) 308 (1946)..... | 20 |
| <i>McFarland v. Commercial Boiler Works</i> , 10 Wn. (2d) 81, 116 P.(2d) 228 (1941)..... | 34 |
| <i>McIntyre v. Kavanaugh</i> , 242 U.S. 138, 37 Sup. Ct. 38 (1916) | 17, 18, 19, 20 |
| <i>Minsky, In re</i> (D.C. N.Y.) 46 F. Supp. 104 (1942) | 20 |
| <i>Ohio Valley Co. v. Mack</i> (C.C.A. 6) 163 Fed. 155, 158 (1906) | 37 |
| <i>Probst v. Jones</i> , 262 Mich. 678, 247 N.W. 779 (1933) | 21 |
| <i>Smith v. Ladrie</i> , 98 Vt. 429, 129 Atl. 302 (1925) | 21 |
| <i>Tinker v. Colwell</i> , 193 U.S. 473, 24 Sup. Ct. 505 (1904) | 20 |
| <i>Ulner v. Doran</i> , 167 App. Div. 259, 152 N.Y. Supp. 655 (1915) | 15, 20 |
| <i>United States v. Mammoth Oil Co.</i> (C.C.A. 8) 14 F. (2d) 705 (1926) reversing 5 F.(2d) 330, certi- orari granted 47 Sup. Ct. 332, 273 U.S. 686, 71 L. ed. 840 affirmed 48 Sup. Ct. 1, 275 U.S. 13, 72 L. ed. 138 | 33 |
| <i>Van Epps v. Aufdemkamp</i> (Cal. Dist. Ct. of App. 2d Dist. Div. 1) 138 Cal. App. 622, 32 P.(2d) 1116 (1934) | 21 |
| <i>Weeks v. Streicher</i> (Ct. of App. Lucas County) 74 Ohio App. 253, 58 N.E.(2d) 415 (1943) | 21 |

STATUTES

| | |
|------------------------------|------------|
| U.S.C. Title 11, §35..... | 13, 14, 15 |
| U.S.C. Title 28, §41-19..... | 1 |
| U.S.C. Title 28, §225..... | 1 |
| U.S.C. Title 28, §230..... | 1 |

COURT RULES

| | |
|--|---|
| Federal Rules of Civil Procedure, Rule 73..... | 1 |
|--|---|

**IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT**

CLARANCE A. REES and EVELYN E. REES,
bankrupts, *Appellants*, }
vs. } No. 11830
SOREN N. JENSEN and ANNA JENSEN, }
Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WASHINGTON,
NORTHERN DIVISION

BRIEF OF APPELLANTS

JURISDICTION

Jurisdiction of the District Court in this cause is based upon U.S.C. Title 28, Section 41-19, conferring upon Federal District Courts original jurisdiction in all matters and proceedings in Bankruptcy.

Jurisdiction of the Circuit Court of Appeals in this cause is based upon U.S.C. Title 28, Sec. 225, authorizing an appeal to a United States Circuit Court of Appeals from a final decision in a Federal District Court and U.S.C. Title 28, Sec. 230, requiring such an appeal to be taken within three months after entry of judgment. In this cause the judgment of the District Court was entered on October 13, 1947 (R. 22) and Notice of Appeal and Supersedeas Bond were duly filed on October 15, 1947 (R. 28) F.R.C.P. Rule 73.

STATEMENT OF THE CASE

Because of the importance of the factual issues, the following extended statement of the case has been thought necessary to a full understanding.

* * * * *

This cause arises out of litigation involving two parcels of land, forming one continuous tract, which lies in the vicinity of Lake Meridian near the point at which Jenkins Creek crosses the James B. Kinne Road, about four miles from the Town of Kent in the State of Washington. One of these parcels, often referred to in the record as "Tax lot 4" and hereafter for convenience so called, is described as follows:

"That portion of said Government Lot 2, lying southeasterly of the Northern Pacific Railroad Company right of way and Westerly of the James B. Kinne Road, Section 2, Township 21 North, Range 5 EWM, situated in King County, Washington, being known as Tax Lot 4." (R. 68).

The other parcel, hereafter referred to as the "Skirving property," is described as follows:

"That portion of the Southeast quarter of the Northwest quarter of Section 2, Township 21, North, Range 5 East WM, lying East of the Northern Pacific Railway Right of Way; and the West 990 feet of the Southwest Quarter of the Northeast Quarter of said Section, less the Northern Pacific Railway Right of Way; and less the South 660 feet of the East 660 feet; less portion of the North 660 feet lying Easterly of Jenkins Creek; and less portion of the South

330 feet of the West 330 feet lying Easterly of Jenkins Creek, together with a right of way for road over that portion of the North 25 feet of the Southwest Quarter of the Northeast Quarter lying between Jenkins Creek and Soos Creek-Berrydale Road; except roads, situated in King County, Washington." (R. 73).

Plats of the area here under discussion are included in the record in this case (R. 59, 60).

Tax lot 4 is a piece of vacant pasture of about 1.5 acres (R. 71) which adjoins along its south boundary the Skirving property and forms a continuation thereof (R. 73). The Skirving property comprises about 22 acres. Upon said tract of land are located certain structures, *viz.*, a house, sheds, barn, and refrigerator car (R. 74-75, 78), whose exact position upon said tract with reference to the boundaries of the Skirving property and Tax lot 4, as will hereafter appear, were determined in the course of and as incident to a proceeding in the Superior Court of the State of Washington for King County, hereafter called the Superior Court. It is these structures whose conversion by appellants gave rise to the judgment debt (R. 78) which, appellants contend, has been discharged.

Appellees owned Tax lot 4 from June, 1929, until April 21, 1932, when a tax deed covering said Tax lot 4 was issued to King County, Washington, as the result of a foreclosure of a certificate of delinquency for general taxes for the years 1924 to 1927 (R. 69-70).

The Skirving property was owned by Cora J. Skirving at the time that appellees acquired Tax lot 4 (R. 73). In 1932, one Doc Hamilton purchased said property from Cora J. Skirving on real estate contract, and in the same year erected thereon a house, sheds, barn and moved a refrigerator car thereon (R. 74). Thereafter certain labor liens were foreclosed thereon, and Cora J. Skirving was made a party defendant. In this foreclosure, Cora J. Skirving entered into a stipulation that the buildings be separated from the land and sold as personality (R. 74). On or about May 9, 1938, appellees purchased said buildings at public auction held in accordance with said stipulation. Appellees thereafter moved the buildings from the place where they were standing onto the north 65 feet of the Skirving property under the mistaken belief that they owned the 65 feet as the south portion of Tax lot 4, a belief shared by Cora J. Skirving (R. 74-75). Neither appellees nor Cora J. Skirving knew where the true boundary line between the Skirving property and Tax lot 4 existed and appellees would neither have continued in possession and maintained the buildings on the north 65 feet of the Skirving property nor would Cora J. Skirving have permitted the appellees to remain in possession of the north 65 feet of the Skirving property if they had known where the true boundary line existed (R. 75).

On or about January 13, 1944, appellants entered into a real estate contract for the purchase of this property from Cora J. Skirving (R. 73-74), by which

Cora J. Skirving undertook to convey the property owned by her "with the appurtenances thereto belonging * * *" (R. 61), and by which appellants agreed to "keep all buildings thereon insured for a sum equal to the deferred payments above specified, in some insurance company satisfactory to said vendor * * *" (R. 62). Appellants immediately took possession thereof, and during the pendency of the action in the Superior Court (hereafter referred to), received a warranty deed of said property from Cora J. Skirving (R. 74).

On or about March 20, 1944, appellants received a conveyance of Tax lot 4 from King County (R. 71), paying therefor to King County the sum of \$50.00 together with the cost thereof amounting to approximately \$9.00 (R. 72).

At the time of the issuance of the deed to Tax lot 4 to appellants, appellees had tenants upon said property (R. 72).

Appellants, by their then attorney, M. L. Longfellow, in a letter dated February 26, 1944, addressed to appellees and their tenants, demanded possession of said property (R. 64, 72), stating as their reason for such demand that:

"There is a dwelling house located in part, possibly, upon this property, but Mr. Rees has purchased other real estate joining this, and consequently is entitled to the dwelling house regardless of whether the same is located upon the real estate herein above described (Tax lot 4), or upon the other tract of real estate which

has been purchased by Mr. Rees (obviously referred to the Skirving property)."

Shortly thereafter, appellants took possession of the premises and retained them (R. 72).

Appellees, in the same year, began a suit in equity in the Superior Court whose purpose, according to the affidavit of appellees' attorney, was "to set aside a certain County Treasurer's Tax Deed issued to the defendants herein covering certain property allegedly belonging to the plaintiffs, and to forever quiet title to the property described in said tax deed in the plaintiffs" (R. 32). This complaint, which is reproduced almost verbatim as a first cause of action in appellees amended complaint (R. 36), was based upon facts allegedly showing that appellees had been frustrated by agents of the Treasurer of King County in their attempt to pay taxes on Tax lot 4, and were, therefore, entitled to relief predicated upon such facts. The structures in question on this appeal were mentioned only incidentally in the complaint as being located upon Tax lot 4, and no relief in any way connected with them was sought.

Appellants on August 31, 1944, gave notice of trial amendment to amend their answer to allege that Tax lot 4 was not improved by any dwelling house and had no improvements of value upon it (R. 30).

Thereupon on September 2, 1944, appellees entered a motion to amend their summons and complaint (R. 31) by adding a new party and new cause of action. In support thereof, appellees' counsel filed an affidavit (R. 32) in which it was deposed that "* * * at the

*time suit was brought and the issues framed by the litigating parties, it was the belief of all said parties plaintiffs and defendants that certain improvements, consisting of a five-room house, outhouse, and sheds of the reasonable value of \$2,000.00 were located upon property described in the Tax Deed [Tax lot 4] * * *” (R. 32). The remainder of the affidavit is concerned with a statement of matter later reproduced as the appellees’ second cause of action, discussed below.*

Upon proper leave, an amended complaint was filed by appellees in the Superior Court on Sept. 6, 1944 (R. 36). The first cause of action alleged facts claimed to entitle appellees to a decree quieting title to Tax lot 4 for the reasons above stated. Appellees’ second cause of action (R. 43) alleges facts calculated to show adverse possession of the north 65 feet of the Skirving property for the prescriptive period by the appellees. In this cause of action, just as in their first cause of action, appellees mentioned the improvements upon the land only incidentally (R. 45, 46), nowhere setting out facts which amounted to an allegation of conversion of the structures even by inference.

After a full trial upon the merits (R. 65), findings of fact and conclusions of law were entered in the Superior Court action. The legal conclusions of the judge of the Superior Court were, first, that appellees had not by clear, cogent and convincing evidence established their right to have title to Tax lot 4 quieted in them (R. 77), and, second, that ap-

pellees' evidence did not establish that they were entitled to the north 65 feet of the Skirving property upon the ground of acquisition by adverse possession. Thereupon, the court noted that the action before it was equitable in nature and that the court had the right to do equity between the parties, having acquired jurisdiction of them and the cause of action (R. 77). Upon the strength of this pronouncement and certain findings of fact set out next below, the court then proceeded to enunciate the bare conclusion that appellants had converted the structures here in question (R. 78).

In support of its determined effort to achieve "equity" between the parties, the court found that the structures upon the north 65 feet of the Skirving property

"have been at all times considered as personality by the plaintiffs and the defendant Skirving [N.B., not the appellants]; and that the time of her sale of said property to the defendants Clarence A. Rees and wife said structures were not included in the sale and no consideration was given for them or either of them. That the defendants Rees and wife never at any time believed they were purchasing said structures, or either of them, having been advised at the time of their purchase that the buildings were no part of the property purchased." (R. 75).

It is upon these narrow factual conclusions that appellees' case must rest.

The extremely restricted scope of these findings is shown by the refusal of the court to find anything

beyond their bare terms. Appellees included in their draft of the findings of fact presented to the court the following relatively innocuous factual conclusion:

"That at the time of the purchase of said property (Tax lot 4) the Defendant Rees and wife, knew the value of said property was greatly in excess of the amount paid, and also knew that plaintiffs were ignorant of the pending proceedings for the sale of said property by the County Treasurer." (R. 72).

which the Superior Court judge struck and deleted (R. 72).

* * * * *

After the rendition of the judgment of the Superior Court, appellants filed a voluntary petition in bankruptcy in the District Court of the United States for the Western District of Washington, Northern Division. In the course of such proceedings, appellees filed objections to the discharge of the bankrupts from the liability evidenced by the Superior Court judgment (R. 2, 3). Upon stipulation of the attorneys for all parties, made in open court on May 6, 1947, the matter was considered and decided upon certain documentary evidence, oral argument and briefs submitted in support of the several contentions of the parties (R. 3, 4). A decision by the referee on objections to release of appellants from the Superior Court judgment (R. 6) was rendered on May 15, 1947, denying release from the judgment to the appellants. Findings of fact and conclusions of law in accordance with referee's decision were entered on May 23, 1947 (R. 13).

Appellants appealed from the decision, findings of fact, and conclusions of law of the referee to the District Court and the court, per Black, J., rendered an oral decision on September 30, 1947 sustaining the referee. An order in accordance with this decision was entered by the court on October 13, 1947.

SPECIFICATION OF ERRORS

1. The District Court erred in sustaining the Decision of the Referee in excepting from the benefit of the discharge, the judgment debt of Soren N. Jensen and Anna Jensen, both in law and in fact.

2. The District Court erred in failing to distinguish between the law here applicable and the law properly applicable only to those conversions arising out of aggravated circumstances.

3. The District Court erred in believing himself bound to uphold the Referee's Decision, when the decision was not supported by the record in the cause, to-wit:

a. Finding of Referee that:

"* * * the buildings were considered and known to all the parties, including the bankrupts, to be the personal property of the judgment creditors * * *. (R. 15)

b. The statement of the Referee that:

the structures "were probably mistakenly placed on Tax Lot 4, which gave rise to this litigation." (R. 8)

c. The inference that the Referee made that the value of Tax Lot 4 was greatly in excess of the amount paid therefor. (R. 8)

d. The statement of the Referee that:

"These circumstances and the fact that the bankrupts did not avail themselves of the privileges of taking the witness stand and explaining what motives they had or what possible justifications they could have in converting to their own uses the personal property of the judgment creditors, leaves the Findings of Fact and Conclusions of Law upon which the judgment is based unanswerable." (R. 8)

4. The District Court erred in not giving the bankrupts the benefit of the presumptions existing in their favor, and placing upon them the burden of proving the debt not dischargeable (R. 27).

5. The District Court erred in giving greater weight to the Referee's Decision than he was legally required to when the same record in its entirety was before him (R. 3, 27).

STATEMENT OF POINTS

I.

Appellees should have shown those aggravated features in appellants' conduct which are a necessary constituent of a wilful and malicious injury to property in order to have estopped appellants from obtaining the benefit of their discharge in bankruptcy.

- A. Not every conversion is a wilful and malicious injury to property within Section 17 (a) (2) of the Bankruptcy Act, 11 U.S.C. §35 (a) (2).
- B. Wilfulness and malice are present only where there is a wanton disregard of the rights of others.
- C. The burden of proof of wilfulness and malice was upon appellees.

II.

Appellants did not act in wanton disregard of appellees' rights; therefore, appellants did not wilfully and maliciously injure appellees' property.

III.

The decision of the Referee in Bankruptcy was based upon facts not of record.

- A. In the face of the express refusal of the Superior Court to so find, the Referee found that appellants knew that the value of Tax Lot 4 was greatly in excess of the amount paid therefor.
- B. The Referee's finding that the structures herein were known to appellants to be the personal property of appellees is without basis in the record.
- C. The Referee ignored the record as to the location upon the land of the structures converted by appellants.

IV.

The Referee, by drawing an inference unfavorable to appellants from their failure to take the witness stand, erroneously shifted the burden of proof.

V.

The district judge erred in sustaining the decision of the Referee.

- A. After indicating that he was unable to perceive any evidence of wanton misconduct by appellants, the district judge erroneously sustained the Referee's decision that appellants had acted wilfully and maliciously.
- B. The district judge accorded excessive weight to the Referee's findings of fact.

ARGUMENT

Section 17 of the Bankruptcy Act, U.S.C. Title 11, Section 35, provides:

“Debts not affected by a discharge.

“(a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are due as a tax levied by the United States, or any state, county, district, or municipality; (2) *are liabilities for obtaining money or property by false pretenses or false representations, or for wilful and malicious injuries to the person or property of another*, or for alimony due or to become due, or for maintenance or support of wife or child, or for seduction of an unmarried female, or for breach of promise of marriage accompanied by seduction, or for criminal conversation; (3) have not been duly scheduled in time for proof and allowance, with the name of the creditor, if known to the bankrupt, unless such creditor had notice or actual knowledge of the proceedings in bankruptcy; or (4) were created by his fraud, embezzlement, misappropriation or defalcation while acting as an officer or in any fiduciary capacity; or (5) are for wages which have been earned within three months before the date of commencement of the proceedings in bankruptcy due to workmen, servants, clerks, or traveling or city salesmen, on salary or commission basis, whole or part time, whether or not selling exclusively for the bankrupt; or (6) are due for moneys of an employee received or retained by his employer to secure the faithful performance by such employee of the terms of/a contract of employment.” (Italics ours)

I.

Appellees should have shown those aggravated features in appellants' conduct which are a necessary constituent of a wilful and malicious injury to property in order to have estopped appellants from obtaining the benefit of their discharge in bankruptcy.

- A. Not every conversion is a wilful and malicious injury to property within Section 17 (a) (2) of the Bankruptcy Act (11 U.S.C.) §35(a)(2)).
- B. Wilfulness and malice are present only where there is a wanton disregard of the rights of others.
- C. The burden of proof of wilfulness and malice was upon appellees.

I. Appellees should have shown those aggravated features in appellants' conduct which are a necessary constituent of a wilful and malicious injury to property in order to have estopped appellants from obtaining the benefit of their discharge in bankruptcy.

This argument is intended to demonstrate that the conduct of appellants which underlies the finding of conversion by the Superior Court is not of that aggravated character essential to a finding of wilfulness and malice within the intendment of Section 17 of the Bankruptcy Act. To achieve this end it is necessary that the applicable law be discussed in some detail.

A. Not every conversion is a wilful and malicious injury to property within Section 17(a)(2) of the Bankruptcy Act (11 U.S.C. §35(a)(2)).

Although the main distinctions made by the courts which have considered these questions are of some nicety, it is abundantly clear that all have agreed that not every conversion is a wilful and malicious injury to property. In the leading case of *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 332, 55 Sup. Ct. 151 (1934), a case of conversion under the provision of the Bankruptcy Act here in point, more fully discussed below, Mr. Justice Cardozo stated:

“There may be a conversion which is innocent or technical, an unauthorized assumption of dominion without wilfulness or malice.”

Likewise, in *In re Levitan* (D.C. N.J. 1915) 224 Fed. 241, 243, 244, the court said:

“In the present case the judicial determination that the defendant was guilty of conversion did not establish that he acted maliciously, for the reason that malice or bad faith is not a necessary element of conversion. If he acted in good faith, the act, though intentional amounting to conversion would not have been malicious, even though it should be ultimately determined to have been legally indefensible. To hold otherwise would be to make all intentional acts falling under the head of torts, resulting in injury to person or property, malicious and nondischargeable in bankruptcy, regardless of the motives which animated them.”

To the same effect are *Brown v. Garey*, 267 N.Y. 167, 196 N.E. 12 (1935); *Ulner v. Doran*, 167 App. Div. 259, 152 N.Y. Supp. 655 (1915).

B. Wilfulness and malice are present only where there is a wanton disregard of the rights of others.

Since all conversions are not from their very nature wilful and malicious, the distinction between those which have such a character and those which do not must be next discussed.

This distinction, which had occasioned some courts no little difficulty until the decision of *Davis v. Aetna Acceptance Co.*, *supra*, was by that decision, it is submitted, firmly grounded upon the difference between acts of conversion indicating a wanton, unconscionable intention in the convertor and acts of conversion which failed to clearly evidence such motivation.

In the *Davis* case, *supra*, the bankrupt, an automobile dealer, borrowed more than one thousand dollars from the judgment creditor to finance the purchase of an automobile. Upon delivery of the automobile to the bankrupt, he gave to the judgment creditor a security title to the automobile by means of a chattel mortgage, a trust receipt, and a bill of sale absolute in form. Shortly thereafter, the bankrupt sold the automobile in the ordinary course of his business and without the consent of the judgment creditor. The creditor obtained a judgment against the bankrupt in an action prosecuted in the courts of the State of Illinois in which the trial court found the bankrupt was "guilty of legal conversion of the property, as described in the count of trover." During the pendency of the action for conversion in the trial court, the bankrupt had filed a petition in bankruptcy and received his discharge. The bankrupt's plea of a dis-

charge in bankruptcy was overruled by the trial court in the action for conversion and judgment was rendered for the creditor. The case was taken from the courts of Illinois to the Supreme Court of the United States, on certiorari, where the judgment was reversed. There, Mr. Justice Cardozo, speaking for the court, on pages 331, 332 and 333, said:

“The respondent contends that the petitioner was liable for a wilful and malicious injury to the property of another as the result of the sale and conversion of the car in his possession. There is no doubt that an act of conversion, if wilful and malicious, is an injury to property within the scope of this exception. Such a case was *McIntyre v. Kavanaugh*, 242 U.S. 138, where the wrong was unexcused and wanton. But a wilful and malicious injury does not follow as of course from every act of conversion, without reference to the circumstances. * * * The discharge will prevail as against a showing of conversion without aggravated features.”

The case of *McIntyre v. Kavanaugh*, 242 U.S. 138, 37 Sup. Ct. 38 (1916), cited with approval in the portion of the *Davis* case above quoted, illustrates the kind of conduct which may prevent the release of a bankrupt. It arose out of an action for conversion of certain stock certificates deposited by the creditor with a firm of brokers as security for the creditor's indebtedness. Within a few weeks after the deposit of the certificates the brokers without authority and without the creditor's knowledge sold the stocks and appropriated the avails to their own use. Shortly thereafter both the firm and its members were ad-

judged bankrupt and plead their discharge in the action for conversion. The trial court expressly found that the conversion was a wilful and malicious injury to the property of the creditor, a fact in itself sufficient to distinguish that case from the instant matter. Moreover, the deliberate and wilful character of the bankrupts' acts in the *McIntyre* case, more consonant with an intentional and knowing disregard of the creditors' rights than with the innocent misadventure of the bankrupts in the instant situation, serves to distinguish the *McIntyre* case. The appropriation of property left with a broker as security, no error or misunderstanding on the broker's part being shown in extenuation, is a very different thing from the error committed by the bankrupt herein acting under the honest belief that he was asserting dominion over his own property.

That the case of *McIntyre v. Kavanaugh, supra*, has been understood as being severely limited in its application since the decision in the *Davis* case, *supra*, is shown by a recent decision of the New York Court of Appeals (the very court whose decision in the *McIntyre* case was affirmed by the United States Supreme Court in the opinion discussed above) in its recent decision in *Brown v. Garey*, 267 N.Y. 167, 196 N.E. 12, 13 (1935). The *Brown* case is important not only for its treatment of the *McIntyre* case, but for the further light that it throws on the distinction between judgments for conversion which may be discharged in bankruptcy and those which may not. The bankrupts, in the *Brown* case, were stockbrokers who received a certificate of stock from the plaintiff for

the sole purpose of having it sold on the New York Stock Exchange. A few weeks later, the bankrupts, without the knowledge, consent or authority of the plaintiffs, pledged the certificates to secure a loan. A few days later, a petition in bankruptcy was filed against the bankrupts. The certificate in question was sold by the pledgee. Upon these facts, whose similarity to those of the *McIntyre* case is apparent, the New York court was called upon to determine whether or not the bankrupts could successfully plead their discharge as a defense in the suit for conversion of the stock certificates. Judgment was given for the bankrupt. The court, after quoting substantially that material from the *Davis* case set forth above, stated on page 13:

“The court must examine the circumstances of each particular case and say whether it finds among them the elements which the law has come to accept as badges of wilfulness and legal malice.

* * * A wrongful act done intentionally which necessarily causes harm and is without just cause or excuse constitutes a wilful and malicious injury. *Kavanaugh v. McIntyre*, 210 N.Y. 175, 182, 104 N.E. 135, affirmed, 242 U.S. 138, 37 S. Ct. 38, 61 L. ed. 205; and cf. *In re Levitan* (D.C.) 224 Fed. 241, 243. * * * Since a wrongful intent is not an essential element of conversion * * *, an act of dominion done under mistake or misapprehension, and without conscious intent to violate right or authority, may yet be a conversion; but it is not a wilful and malicious conversion even though the mistake or misapprehension is due to negligence, the rule can be no different.”

At another point in its opinion, on page 13, the court in discussing the *McIntyre* case said:

"The conversion was larcenous in its nature and the injury was held to be wilful and malicious."

To the same effect are the cases of *Massachusetts Bonding Co. v. Lineberry*, 320 Mass. 410, 70 N.E.(2d) 308 (1946); *Emigh v. Lohnes*, 21 Wn.(2d) 913, 153 P.(2d) 869 (1944); *In re La Porte* (D.C. W.D.N.Y.) 54 F. Supp. 911 (1943); *In re Levitan* (D.C. N.J.) 224 Fed. 241 (1915); *Ulner v. Doran*, 167 App. Div. 259, 152 N.Y. Supp. 655 (1915).

To be sharply distinguished from the line of authority properly applicable here are such cases as *Tinker v. Colwell*, 193 U.S. 473, 24 Sup. Ct. 505 (1904); *In re Freche* (D.C. N.J.) 109 Fed. 620 (1901) involving such quasi-criminal acts of bankrupts as criminal conversation and seduction which import a wanton disregard for the rights of others in their very nature. To liken such acts to the unintentional appropriation of structures, normally regarded as appurtenant to the land, ambiguously located upon property clearly owned by a bankrupt would be highly inexact.

Also to be distinguished are such cases as

McIntyre v. Kavanaugh, 242 U.S. 138, 37 Sup. Ct. 38 (1916);

In re Minsky (D.C. N.Y.) 46 F. Supp. 104 (1942);

In re Green (C.C.A. 7) 87 F.(2d) 951 (1937);

Matter of Goldstein (D.C. S.D.N.Y.) 30 F. Supp. 443 (1939);
Weeks v. Streicher (Ct. of App. Lucas County) 74 Ohio App. 253, 58 N.E.(2d) 415 (1943);
Matter of Buzas (D.C. N.D.Cal.) 58 F. Supp. 717 (1944);
Probst v. Jones, 262 Mich. 678, 247 N.W. 779 (1933);
In re Blauweiss (City Ct. of N.Y. Queens County) 23 N.Y. Supp. (2d) 907 (1940);
In re Gumbinsky (D.C. W.D.N.Y.) 8 F. Supp. 601 (1934);
Van Epps v. Aufdemkamp (Cal. Dist. Ct. of App. 2d Dist. Div. 1) 138 Cal. App. 622, 32 P.(2d) 1116 (1934);
Smith v. Ladrie, 98 Vt. 429, 129 Atl. 302 (1925);
Frangos v. Frangos (Superior Ct. Pa.) 157 Pa. Super 87, 31 A.(2d) 416 (1945).

In these cases, either upon the strength of an express finding of wilfulness and malice by the trial court, or after recognizing that there must be a wanton disregard of other's rights upon evidence of such disregard as is satisfactory to them, reviewing courts have refused to recognize discharges of bankrupts from judgments based upon conversion.

To sum up, appellants contend that the law properly applicable to the facts of this case should result in their discharge from a judgment arising out of conversion unless it clearly appears that they have engaged in conduct so shocking to the conscience of the

court and the community that they are not worthy of freedom from the burden of such a liability. The "aggravated circumstances" referred to in the opinion of Mr. Justice Cardozo in the *Davis* case, *supra*, mark the line between conduct which would preclude them from obtaining the benefit of a discharge in bankruptcy, and conduct which is wrongful but will not have this result.

C. *The burden of proof of wilfulness and malice was upon appellees.*

The burden of proving the existence of unconscionable conduct by appellants was upon the appellees.

As was said in *Kreitlein v. Ferger*, 238 U.S. 21, 26, 35 Sup. Ct. 685 (1915) :

"There are only a few cases dealing with the subject, but they almost uniformly hold that where the bankrupt is sued on a debt existing at the time of filing the petition, the introduction of the order makes out a *prima facie* defense, the burden being then cast upon the plaintiff [here appellees] to show that, because of the nature of the claim * * * or other statutory reasons, the debt sued on was by law excepted from the operation of the discharge."

Kreitlein v. Ferger was followed in *Brown v. Garey*, *supra*, where, on page 13, the court rested its conclusions upon the premise that the burden was upon the plaintiff to show that the bankrupts "without just cause or excuse and knowing that it would necessarily cause him harm" have engaged in an allegedly wilful and malicious injury to property.

In *In re Levitan, supra*, at page 243, a case similar in its facts to the instant case, the court said:

"It being a provable debt in bankruptcy, the burden of proof is upon the judgment creditor to show that such liability is within the exception of Section 17 (a) (2)."

For the reasons which appear below, appellees have failed to sustain the burden incumbent upon them.

II. Appellants did not act in wanton disregard of appellees' rights; therefore, appellants did not wilfully and maliciously injure appellees' property.

During the entire course of their dealings with the land and structures involved in this case, appellants acted in a manner completely at variance with the criteria of wilfulness and malice laid down in the *Davis* and allied cases. Appellants' conduct was much more consistent with an honest belief in the validity of their claim to the structures converted by them, or, at least with a state of innocent confusion about the merit of such claim than with a wanton disregard of appellees' rights in these structures.

It is established beyond any doubt that the structures converted were, at all times during the pendency of this controversy, and for long prior thereto located upon the Skirving property (R. 74-75, 78). It is also apparent from the sworn admission of appellees' attorney (R. 32) and the appellants' notice of trial amendment (R. 30) that until the Superior Court proceeding was well advanced all parties believed that these structures were located upon Tax Lot 4.

Wholly consistent with this belief of appellants is the letter of appellants' attorney, dated February 26, 1944, sent to appellees and their tenants before the commencement of the Superior Court proceedings, in which letter appellants' attorney stated that one of the structures in question was located

"in part possibly upon this property" [Tax Lot 4] and went on to relate that 'Mr. Rees has purchased other real estate adjoining this, and consequently is entitled to the dwelling house regardless of whether the same is located upon the real estate herein above described [Tax Lot 4] or upon the other tract of real estate which has been purchased by Mr. Rees'."

[Skirving property] (R. 64-65). This letter clearly shows that appellants regarded the structures as belonging to them by virtue of their ownership of Tax Lot 4, that they at least conceived the possibility that there might be some doubt about the location of the structures with relation to the two parcels and that despite such doubt, they claimed the structures as appurtenant either to Tax Lot 4 or the Skirving property.

Appellants' belief that the structures were appurtenant to one or the other, or both, of the parcels owned by them was logically grounded in the real estate contract for the purchase of the Skirving property in which their grantor undertook to convey the land owned by her "with the appurtenances thereto belonging" (R. 61).

The very course of the proceedings in the Superior Court strengthens the inescapable impression that, far

from acting in unconscionable disregard of appellees' rights, appellants were asserting a well-founded claim to the structures. Appellees' complaint, reproduced in substance as the first cause of action in appellees' amended complaint (R. 36) requested no relief in any way connected with the structures upon the land. The only purpose of the complaint was "to set aside a certain County Treasurer's Tax Deed issued to the defendants herein * * *, and to forever quiet title to the property described in the said tax deed in the plaintiffs" (R. 32).

Appellees' amended complaint (R. 36) filed after the exact location of the structures had been determined, still made no effort to bring into the controversy the structures upon the Skirving property. The first cause of action in the amended complaint repeated the essential allegations of the complaint and requested the relief therein sought (R. 36). The second cause of action in the amended complaint (R. 43) made no more of the facts surrounding the conversion of the structures, but confined itself to setting up facts which alleged ownership of the north 65 feet of the Skirving property by virtue of adverse possession by appellees. Appellees, at least until the trial stage of the Superior Court proceedings, apparently had not seen the structures as other than a part of the land upon which they were located. If they had, it is only logical to expect that they would have made more than a passing reference to the structures in all of their pleadings and would have sought some relief with regard to the structures considered as separate from the land.

Where appellees, who had participated in all of the transactions leading up to the separation of the structures from the land, did not, until the pleading stage of the Superior Court proceedings had been passed, realize that their rights in such structures had been violated, it is hard to conceive how appellants, acting prior to the institution of the Superior Court proceedings and without the advantage of full acquaintance with all of the transactions leading up to the separation of structures and land possessed by appellees, could have converted such structures in such utter disregard of appellees' rights as would constitute a wilful and malicious injury to property.

The fact that the trial judge in the Superior Court, in order to support his effort to achieve "equity" between the parties, found it necessary to rest his conclusion that a conversion had occurred upon a finding that, at the time of the sale of the Skirving property to appellants by appellants' grantor, the "structures were not included in the sale and no consideration was given for them or either of them," and upon the further finding that appellants "never at any time believed they were purchasing said structures, or either of them, having been advised at the time of their purchase that the buildings were no part of the property purchased" [Skirving property] (R. 75) should not conceal the fact that these findings are only the formal requisites of any judgment for conversion and do not demonstrate, in themselves, any malicious or wilful conduct of appellants.

The restricted availability of these findings as a

foundation upon which to rest the conclusion that appellants were wilful or malicious may be appreciated in the light thrown upon them by the refusal of the Superior Court judge to find any facts which would tend to show any malice or wilfulness in the appellants. In fact from the findings of fact presented by appellees' attorney, the Superior Court judge even struck the following:

"That at the time of the purchase of said property the defendants Rees and wife knew the value of said property was greatly in excess of the amount paid, and also knew that plaintiffs were ignorant of the pending proceedings for the sale of said property by the treasurer to them."

(R. 72)

That appellees' case, when rested only upon those findings made by the Superior Court, lacked sufficient evidence of wilfulness and malice, was apparently recognized by the Referee in Bankruptcy in the proceedings with regard to appellees' objections. The Referee found, as an ultimate fact, that:

"It is more logical to believe that when Clarence A. Rees filed his application to purchase Tax Lot 4 * * *, and made his bid therefore, the sum of \$50.00, that he was bidding for the land and not for the buildings, which of themselves were worth \$1,000.00 or more." (R. 8)

This factual conclusion by the Referee, upon which he directly rests his decision to sustain appellees' objections (R. 8), is the merest restatement of the proposed finding of fact to the effect that

"at the time of the purchase of said property the defendants Rees and wife knew the value of said

property was greatly in excess of the amount paid, * * *." (R. 72)

which finding was expressly refused by the Superior Court. Yet without this finding the Referee apparently felt unable to conclude that there was wilful and malicious conduct by appellees.

In view of all of the foregoing facts, appellants urge that they committed no wilful or malicious injury to appellees' property.

III. The decision of the Referee in Bankruptcy was based upon facts not of record.

- A. In the face of the express refusal of the Superior Court to so find, the Referee found that the appellants knew that the value of Tax Lot 4 was greatly in excess of the amount paid therefor.
- B. The Referee's finding that the structures herein were known to appellants to be the personal property of appellees is without basis in the record.
- C. The Referee ignored the record as to the location upon the land of the structures converted by appellants.

The decision of the Referee in Bankruptcy on objections to the bankrupts' release from the judgment for conversion (R. 6) is based upon certain factual inferences without support in the record, and a finding of fact which shows a patent failure to comprehend even the most obvious circumstances of this proceeding.

A. In the face of the express refusal of the Superior Court to so find, the Referee found that appellants knew that the value of Tax Lot was greatly in excess of the amount paid therefor.

As shown above at page 27 of this brief, the Referee in Bankruptcy found, in substance, that appellants knew at the time of the purchase of Tax Lot 4 that the value of said property was greatly in excess of the amount paid. As was previously shown, this finding was made in the very teeth of an express refusal by the Superior Court judge, who had heard all of the evidence, to make the same finding.

B. The Referee's finding that the structures herein were known to appellants to be the personal property of appellees is without basis in the record.

The Referee's arbitrary action in this respect is important, not only because it clearly demonstrates his failure to grasp the limited scope of the judgment for conversion, but also because it is one of the main supports for his conclusion that appellants acted maliciously and wilfully.

The Referee's failure to grasp the essential facts of his controversy is further demonstrated by his finding that the structures:

“* * * were considered and known to all the parties, including the bankrupts, to be the personal property of the judgment creditors * * *. (R. 15).

The Superior Court record may be searched in vain for a substantially similar finding by that court. The find-

ing of the Superior Court closest in its language to that of the referee is the following:

"That the houses, sheds, barns and each structure now upon said North 65 feet have been at all times considered as personality by the Plaintiffs and the Defendant *Skirving* (Italics ours); * * *." (R. 75)

The difference between a finding that appellants' grantor had certain knowledge and a finding that appellants had the same knowledge is too obvious to be labored.

Findings as detrimental to the appellants as this should not have been made by one as far removed from the facts of the case as the Referee herein without substantial support for such findings in the record. The Referee appears to have been excessively prone to draw inferences unfavorable to appellants.

C. The Referee ignored the record as to the location upon the land of the structures converted by appellants.

In the Referee's decision on objections to release from judgment (R. 6) the following statement appears:

"Of great and controlling importance in this case are the facts that the buildings belonging to the Jensens and converted by the Rees' were personal property, had been severed from the realty in a lien foreclosure against "Doc" Hamilton, and had been physically removed from the place they were originally constructed and *probably mistakenly placed upon Tax Lot 4*, which gave rise to this litigation." (Italics ours) (R. 7-8).

It is inconceivable that anyone with even a minimal grasp of the facts in the Superior Court record could, in view of the large role assumed in that proceeding by the determination of the exact location of the structures, have stated that such structures were "probably mistakenly placed upon Tax Lot 4." The fact that such structures were *not* upon Tax Lot 4 caused appellants to serve a notice of trial amendment (R. 30), appellees to enter a motion and affidavit to amend their summons and complaint in which the correct facts with respect to the position of the structures are clearly set forth (R. 31) and to add an entire, new cause of action in their amended complaint (R. 36), and caused the Superior Court to enter detailed findings about the exact location of the property (R. 74-75).

From a statement of the facts with regard to the structures which included the wholly erroneous statement that they were placed upon Tax Lot 4, an inference that the appellants' bid of \$50.00 was made for the land and not the structures thought to be upon it, which the Superior Court had expressly refused to draw, and a further highly doubtful inference, to be discussed below, the Referee concludes that the findings of fact and conclusions of law upon which the Superior Court's judgment was based were "unanswerable," and that appellants, consequently, had wilfully and maliciously injured appellees' property.

IV. The Referee, by drawing an inference unfavorable to appellants from their failure to take the witness stand, erroneously shifted the burden of proof.

The Referee heavily rested his conclusion that appellants had committed a wilful and malicious injury to appellees' property upon a factual inference expressed in the following terms:

"These circumstances and the fact that the bankrupts did not avail themselves of the privilege of taking the witness stand and explaining what motives they had or what possible justifications they could have in converting to their own use the personal property of the judgment creditors, leaves the Findings of Fact and Conclusions of Law upon which the judgment is based unanswerable." (italics ours) (R. 8).

The effect of this finding was to shift the burden of justifying the conversion to appellants. As shown above, the burden of proving that appellees' judgment debt was excepted from the effect of the discharge in bankruptcy was, and remained upon, the appellees throughout the course of the proceedings before the Referee.

Furthermore *appellees* "did not avail themselves of the privilege of taking the witness stand" to sustain *their* burden of proving appellants' alleged wilfulness and malice.

Where the burden of proof was upon appellees, and profferred no testimony to support their burden, the Referee should not have drawn a more unfavorable inference from appellants' failure to do the very thing that appellees, who had the greater burden, did not themselves do.

The case of *United States v. Mammoth Oil Co.* (C.C.A. 8) 14 F.(2d) 705 (1926) reversing 5 F.(2d) 330, certiorari granted 47 Sup. Ct. 332, 273 U.S. 686, 71 L.ed. 840 affirmed 48 Sup.Ct. 1, 275 U.S. 13, 72 L.ed. 138, involved an issue upon which it was necessary for the plaintiff to show the circumstances of the transfer of certain bonds from one of the defendants to another party. The court held that the plaintiff must produce affirmative proof of facts *prima facie* sufficient to sustain his contentions before inferences could be drawn from the silence of the defendant. The court stated on page 730:

“The silence of one who should speak may well create an inference adverse to him . . .

“Of course, a plaintiff in a case cannot insist that defendant must furnish evidence he may have or permit plaintiff to succeed, and there must be affirmative proof of facts *prima facie* at least to sustain plaintiff’s contentions before inferences [from defendant’s silence] can be properly drawn.”

W. F. Corvin & Co. v. United States (C.C.A. 6) 181 Fed. 296, 104 C.C.A. 270 (1910) was a case involving an action to confiscate whisky for substitution of the contents of the barrels in question after leaving the bonding house. The case turned on the issue of the *intent* to defraud. When the plaintiff attempted to show intent by the silence of the defendant on that issue, the court at page 304 stated:

“* * * but they do not go to the extent of holding that where there is a total lack of evidence tending to show guilt, mere silence of the party pro-

ceeded against may be the basis of a presumption of his guilt."

To the same effect see *McFarland v. Commercial Boiler Works*, 10 Wn.(2d) 81, 116 P.(2d) 228 (1941).

This inference, together with the equally erroneous inference to the effect that appellants knew that the value of Tax Lot 4 was greatly in excess of the amount that they had paid therefor (R. 8) (the latter inference having been discussed in the preceding section of this argument), are the main supports of the Referee's conclusions adverse to appellants. Without these supports the Referee's conclusions must fall of their own weight.

V.

The District Court erred in sustaining the decision of the Referee.

- A. After indicating that he was unable to perceive any evidence of wanton misconduct by appellants, the District Court erroneously sustained the Referee's decision that appellants had acted wilfully and maliciously.
- B. The District Court accorded excessive weight to the Referee's findings of fact.

As has been already shown, the Referee's decision was without a basis in fact and law. The decision of the District Court sustaining the Referee's decision must fall with the collapse of the latter.

A. After indicating that he was unable to perceive any evidence of wanton misconduct by appellants, the District Court erroneously sustained the Referee's decision that appellants had acted wilfully and maliciously.

In the course of the oral decision of the District Court (R. 23), there appear the following statements:

“If the matter were before me as a matter of first impression and without restriction by judicial decisions of courts which bind me, I would have no great difficulty. * * *

“With no decisions to guide my course, I am inclined to believe that I would consider that language as not protecting the judgment of Mr. and Mrs. Jensen. But I am bound and controlled by a forest of authority. The weight of authority is to the effect that those simple words (referring to Section 17 (a) (2) of the Bankruptcy Act) include intentional conversion of the kind which Judge Ronald in his findings determined occurred on the part of the bankrupts as against the property of Mr. and Mrs. Jensen. As a result, I feel that in the light of the authorities which control me I must sustain, and therefore I do sustain the decision of the Referee.” (R. 24,25).

The court, further, said:

“I feel I have no right to go further. I would not be justified in overruling the Referee by virtue of the feeling that I have that were there no decisions controlling me, that my opinion might be different. I can and will say that I am not absolutely certain that the Referee was correct. However, the records here, the arguments and the authorities sufficiently indicate that he is correct that I would have no right to reverse

his conclusion. I am not indicating that my mind is evenly balanced as to whether or not the Referee is correct. Even in that event I take it that I should allow his ruling to stand. * * *"
(R. 27).

The attitude of reluctant acquiescence in the decision of the Referee, expressed in the foregoing excerpts from the decision of the District Court, ill accords with the conclusion that acts of appellants were wanton and disregardful of the rights of others. The District Court's expressed feeling that his opinion might be different if there were no decisions controlling him (R. 27), his statement that with no decisions to guide his course he would not consider the language of the Bankruptcy Act as protecting the judgment of the appellees (R. 25) do not show that degree of indignation which would naturally be forthcoming from one who clearly perceived the presence of acts done in unconscionable disregard of the rights of innocent persons.

The forest of authority that the District Court felt controlled and bound him, no doubt refers to those cases cited by the Referee in his decision on objections to appellants' release from appellees' judgment (R. 10) which have been distinguished hereinabove.

B. The District Court accorded excessive weight to the Referee's findings of fact.

By such statements in his decision as: "I am not indicating that my mind is evenly balanced as to whether or not the Referee is correct. Even in that event I take it that I should allow his ruling to stand"

(R. 27) and "As a result, I feel that in the light of authorities which control me I must sustain, and therefore I do sustain the decision of the Referee" (R. 25), the District Court indicated that he felt that he labored under a greater duty to respect the findings of the Referee than was legally required in the circumstances. This was not a matter in which the Referee's findings were based upon opportunities to hear testimony and observe the demeanor of witnesses. The Referee's findings were based upon written evidence as available to the District Judge as to the referee.

In *In re Bowen* (D.C. E.D. Pa.) 58 F. Supp. 286, 294 (1944) affirmed (C.C.A. 3) 151 F.(2d) 690 (1945) the court said:

"Where the findings of referee represent deductions from established facts, they are entitled to little weight on certificate for review because the judge, from the same facts, could as well draw inferences or deduce conclusions as the referee."

In a leading case on this point, *Ohio Valley Co. v. Mack* (C.C.A. 6) 163 Fed. 155, 158 (1906), there appears the following statement:

"No arbitrary rule can be laid down for determining the weight which should be attached to a finding of fact by a bankrupt referee. * * * Much in both cases must depend upon the character of the finding. If it be a deduction from established fact, the finding would not carry any great weight, for the judge, having the same facts, may as well draw inferences or deduce a conclusion as the referee."

To the same effect is *In re Hercules Gasoline Co.* (C.C.A. 9) 76 F.(2d) 677 (1935).

CONCLUSION

In conclusion, appellants respectfully submit that appellees have not sustained their burden of proving a wilful and malicious injury to their property by appellants so as to except their judgment from the discharge in bankruptcy. The Referee's decision to the contrary is supported by an erroneous view of both the applicable law and the facts. The decision of the District Court, sustaining the decision of the Referee, cannot stand alone, but must fall with the Referee's decision. In addition, the decision of the District Court is based upon a misconception of the applicable law, and an erroneous view of the weight to be accorded the Referee's finding.

Appellants respectfully submit that the judgment insofar as it excepts the judgment debt of the Jensens from the discharge in bankruptcy should be reversed.

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Appellants,

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APPEAL FROM THE UNITED STATES DISTRICT COURT
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BRIEF OF APPELLEES

FILED

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INDEX

| | Page |
|--|------|
| Jurisdiction | 1 |
| Summary of Proceedings..... | 2 |
| Summary of Argument | 3 |
| Argument | 4 |
| 1. Do the Facts Show An Intentional Unlawful Conversion of Appellees' Property By Appellants? | 4 |
| The Superior Court Record..... | 4 |
| (a) The pleadings | 4 |
| (b) The Findings of Fact and Conclusions of Law | 6 |
| (c) The exhibits offered in evidence by appellants | 9 |
| 2. Does An Intentional Unlawful Conversion Come Within the Meaning of "Wilful and Malicious Injuries to the Person and Property of Another"? | 12 |
| (a) Intentional conversion is a wilful and malicious injury to the property of another | 12 |
| (b) Actual words of the statute need not be pleaded | 20 |
| Comments on Brief of Appellants..... | 22 |
| 1. Conversion of the Property of Appellees..... | 22 |
| 2. The Burden of Proof..... | 24 |
| 3. Appellants Claim They Were Confused Regarding Their Rights..... | 25 |
| 4. The Stricken Paragraph in the Lower Court's Findings | 26 |
| 5. The Referee's Inadvertence in Describing Property | 29 |
| 6. The District Court's Decision | 29 |
| Conclusion | 31 |

TABLE OF CASES

| | <i>Page</i> |
|---|-------------|
| <i>Andrews v. Dresser</i> (N.Y.) 108 N.E. 1088..... | 21 |
| <i>Baker v. Bryant Fertilizer Co.</i> , 46 A.B.R. 579..... | 19 |
| <i>Bever v. Swecker</i> (1908) 138 Ia. 728, 116 N.W. 704 | 16 |
| <i>Binsky, Matter of</i> , 24 A.B.R. 496..... | 18 |
| <i>Blauweiss, In re</i> , 23 N.Y.S.(2d) 907..... | 19 |
| <i>Brier, In re</i> , 2 A.B.R. (N.S.) 756..... | 19 |
| <i>Buzas, Matter of</i> , 58 F. Supp. 717..... | 19 |
| <i>Campbell v. Gates</i> , 239 N.Y. 457..... | 19 |
| <i>Caplan, In re</i> (C.C.A. 2) 149 F.(2d) 731..... | 4 |
| <i>Carr v. So. Pac. Co.</i> (C.C.A. 9) 128 F.(2d) 76..... | 4 |
| <i>Christal v. Clisbe</i> (Mass.) 76 N.E. 11..... | 17 |
| <i>Covington v. Rosenbusch</i> , 42 A.B.R. 400..... | 18 |
| <i>Davis v. Aetna Acceptance Co.</i> , 293 U.S. 328..... | 23 |
| <i>Eastern Oil Co., In re</i> (C.C.A. 9) 100 F.(2d) 341..... | 4 |
| <i>Frangos v. Frangos</i> , 41 Atl.(2d) 416..... | 19 |
| <i>Franks, In re</i> , 17 A.B.R. (N.S.) 304..... | 19 |
| <i>Freche, In re</i> , 109 Fed. 620..... | 15, 23 |
| <i>Greenfeld v. Tucillo</i> (C.C.A. 2, 1942) 49 A.B.R. (N.S.) 529..... | 18 |
| <i>Globe Indemnity Co. v. Granskar</i> , 16 N.W.(2d) 437 | 19 |
| <i>Goldstein, Matter of</i> , 30 F. Supp. 443..... | 19, 20 |
| <i>Greene, In re</i> , 87 F.(2d) 951..... | 20 |
| <i>Gumbinsky, Matter of</i> , 8 F. Supp. 601..... | 18 |
| <i>Heaphy v. Kerr</i> , 180 N.Y.S. 542..... | 21 |
| <i>Kauk v. Anderson</i> (C.C.A. 8) 137 F.(2d) 231..... | 4 |
| <i>Keeler, In re</i> , 40 A.B.R. 231, 243 Fed. 770..... | 18 |
| <i>Knights Products Inc. v. Donnen Fuel Co.</i> , 20 N.Y. S.(2d) 135 | 19 |
| <i>MacGowan v. Barber</i> (C.C.A. 2) 127 F.(2d) 458..... | 4 |
| <i>McIntyre v. Kavanaugh</i> , 242 U.S. 138..... | 15, 21 |
| <i>Minsky, Matter of</i> , 46 F. Supp. 104..... | 20 |
| <i>Newman v. Burnham</i> (C.C.A. 6) 126 F.(2d) 336..... | 4 |

TABLE OF CASES

v

Page

| | |
|---|--------|
| <i>Norby v. Cain</i> , 176 S.E.(2d) 813..... | 20 |
| <i>Nordlight, In re</i> , 22 A.B.R. 481..... | 19 |
| <i>Northrup, In re</i> , 265 Fed. 420..... | 21 |
| <i>Probst v. Jones</i> , 247 N.W. 779..... | 19 |
| <i>Smith v. Ladrie</i> , 129 Atl. 302..... | 19, 20 |
| <i>Stark, In re</i> , 18 A.B.R. (N.S.) 278..... | 19 |
| <i>Stenger, In re</i> , 49 A.B.R. 224..... | 19 |
| <i>Tinker v. Colwell</i> , 193 U.S. 473..... | 12, 23 |
| <i>Van Epps v. Aufdemkamp</i> , 32 P.(2d) 1116..... | 19 |
| <i>Weeks v. Streicher</i> , 58 N.E.(2d) 415..... | 19 |
| <i>Weisstein Bros. & Survol v. Laugharn</i> (C.C.A. 9) 84 F.(2d) 419 | 4 |
| <i>Werner, In re</i> , 88 F.(2d) 899, 33 A.B.R. (N.S.) 656 | 21 |
| <i>Williamson v. Williams</i> (C.C.A. 4) 137 F.(2d) 341 | 4 |
| <i>Woelfle v. Giles</i> , 184 S.W.(2d) 177..... | 19 |
| <i>Wood v. Fisk</i> , 109 N.E. 177..... | 21 |

TEXTBOOKS

| | |
|--|----|
| 4 Words and Phrases (2nd Series) 1312..... | 20 |
|--|----|

STATUTES

| | |
|---|-----------------|
| Bankruptcy Act. §17(a)2..... | 1, 2, 3, 24, 32 |
| Remington on Bankruptcy, Vol. 7, 813..... | 18 |
| 11 U.S.C. §35(a) (2)..... | 1 |
| 28 U.S.C. §41-19 | 1 |
| 28 U.S.C. §225..... | 2 |

**IN THE
UNITED STATES
CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT**

CLARANCE A. REES and EVELYN E. REES,
bankrupts, *Appellants,*

vs.

Appellants,

SOREN N. JENSEN and ANNA JENSEN,
Appellees.

No. 11830

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WASHINGTON,
NORTHERN DIVISION

BRIEF OF APPELLEES

JURISDICTION

As stated in Appellants' brief, jurisdiction of the District Court is based upon U.S.C. Title 28, Section 41-19, relating to proceedings in Bankruptcy, and specifically upon Section 17(a)(2) of the Bankruptcy Act, 11 U.S.C. Sec. 35(a)(2) which provides:

“Debts not affected by a discharge.

"(a) A discharge in bankruptcy shall release a bankrupt from all his provable debts, whether allowable in full or in part, except such as * * * (2) are liabilities for obtaining money or property by false pretenses or false representations, or for *wilful and malicious injuries to the person or property of another.*" * * * (Italics ours)

Jurisdiction of this court is based upon U.S.C. Title 28, Sec. 225, authorizing an appeal to the United States Circuit Court from a final decision of a Federal District Court.

SUMMARY OF PROCEEDINGS

The appellees, Soren N. Jensen and Anna Jensen, his wife, are judgment creditors of appellants, having obtained a judgment for \$1064.90 on June 5, 1945, in the Superior Court of the State of Washington for King County for the unlawful and intentional conversion of a house and other structures located upon property purchased by appellants from one Cora J. Skirving, which they knew at the time of the purchase were not included in the sale, and which they also knew to be the property of another (Bankrupts' Ex. 3, R. 65-75-76-78).

In order to avoid the judgment, appellants filed a petition in bankruptcy in the Federal District Court for the Western District of Washington, Northern Division. Appellees resisted the discharge, on the ground that their judgment debt was not dischargeable under Sec. 17(a)(2) quoted above.

The litigating parties stipulated that the Referee in Bankruptcy assume jurisdiction of the issues raised (R. 3), and thereafter appellants offered and the Referee received in evidence, along with other papers, the pleadings and Findings of Fact and Conclusions of Law and Decree of the King County Superior Court.

After taking the matter under advisement, the Ref-

eree granted a discharge to the bankrupts, excepting therefrom the judgment debt (R. 20).

Feeling aggrieved thereby, appellants filed a petition for review to the District Court, and after hearing oral argument and considering the law and the facts and the records of both the Bankruptcy Court and the King County Superior Court (R. 24), the District Court sustained the Referee's decision (R. 21).

Feeling now aggrieved at the King County Superior Court's decision, the Referee's decision and the District Court's decision, appellants seek a further review by this court.

SUMMARY OF ARGUMENT

The court is concerned here with one question:

Is the appellees' judgment debt dischargeable in bankruptcy?

To resolve it, two other questions must be answered:

1. Do the facts upon which the judgment was based show an intentional unlawful conversion of appellees' property by appellants?
2. Does an intentional unlawful conversion of property constitute "wilful and malicious injuries to the person and property of another," as required under Section 17(a)(2) of the Bankruptcy Act?

If these two questions are answered affirmatively, it then follows that the appellees' judgment debt is not dischargeable, and the decision of the Referee in Bankruptcy excepting the debt from the discharge and

the order of the District Court sustaining the Referee will stand.

This court will not disturb the concurrent findings of the Referee and the District Court except for mistake or a miscarriage of justice.

In re Eastern Oil Co. (C.C.A. 9) 100 F.(2d) 341;

Newman v. Burnham (C.C.A. 6) 126 F.(2d) 336;

Carr v. So. Pac. Co. (C.C.A. 9) 128 F.(2d) 764, 768;

In re Caplan (C.C.A. 2) 149 F.(2d) 731;

MacGowan v. Barber (C.C.A. 2) 127 F.(2d) 458;

Kauk v. Anderson (C.C.A. 8) 137 F.(2d) 231;

Williamson v. Williams (C.C.A. 4) 137 F.(2d) 341;

Weissstein Bros. & Survol v. Laugharn (C.C.A. 9) 84 F.(2d) 419, 420.

ARGUMENT

1. Do the Facts Show An Intentional Unlawful Conversion of Appellees' Property By Appellants?

Let us look at the record made in the Superior Court, upon which the Referee and the District Court made their findings, conclusions and decrees.

The Superior Court Record

(a) The pleadings

The pleadings in the Superior Court action are significant because the issue of unlawful, intentional

conversion was placed squarely before the court. It was pleaded in the complaint and admitted in the answer.

Appellees as plaintiffs brought an equitable action against defendants for the recovery of certain real property and buildings, upon the grounds of equitable frustration, adverse possession, and unlawful conversion of a house and other structures located upon one of the tracts involved.

Specifically, it was alleged that plaintiffs and one Cora J. Skirving owned adjacent lands. Upon the Skirving property were located a house and certain other structures which plaintiffs purchased at a sheriff's foreclosure sale as separate personal property. Plaintiffs attempted to move all the structures to their adjoining property, but due to a mutual misunderstanding of the true boundary line between the two properties, the buildings were removed to another portion of the Skirving property about 65 feet north of the boundary line.

According to plaintiffs' complaint, defendants, appellants here, purchased the Skirving property as vacant land, knowing at the time that the improvements were no part of the sale, and they paid no consideration therefor (R. 46). Immediately thereafter they unlawfully and wrongfully took possession of the buildings, and denied plaintiffs the use and enjoyment thereof (R. 42-43-45-46). In plaintiffs' prayer for relief they sought to be restored to full possession and ownership of the buildings, for reimbursement for loss of rentals, and for such other and further relief

as to the court might seem right and proper (R. 47-48).

Defendants answered the complaint, admitting that the buildings described in the complaint were considered as personality and were separate and apart from the land they purchased, admitted that plaintiffs purchased the buildings at sheriff's sale and moved them to another part of the land (R. 56), and freely admitted that as soon as they purchased the land from Cora J. Skirving they took possession of plaintiffs' buildings (R. 54).

(b) The Findings of Fact and Conclusions of Law

Upon the issues so framed the case went to trial, and the Superior Court made the following pertinent Findings of Fact (R. 72) :

“XII.

“That at the time of the issuance of the deed to Defendants, Rees and wife, the Plaintiffs had tenants upon said property, and that Defendants Rees and wife demanded that said tenants immediately leave the premises and deliver up physical possession to them; and that immediately thereafter the Defendants Rees and wife took possession of the premises and have kept same up to the present time,, over the objections of Plaintiffs.

“XVI.

“That in 1932, one Doc Hamilton purchased the aforesaid property on real estate contract, and in 1932 erected a house, sheds, barn and removed a refrigerator car thereon; that thereafter certain labor liens were foreclosed thereon, and Cora J. Skirving was made a party defendant.

That subsequently she entered into a stipulation in said action that the buildings be separated from the land and sold as personality, and the title to her land be free from any cloud thereby.

“XVII.

“That, in accordance with said stipulation, on or about May 9, 1938, said buildings were offered for sale at public auction by the Sheriff of King County and that Plaintiffs purchased the same. That thereafter Plaintiffs removed all of said buildings from the particular place where they were then standing onto the North 65 feet of the above described property, by mistake and inadvertance and under the mistaken belief that they owned said property as the south portion of Lot 4. That at said time it was the general belief of both Plaintiffs and the Defendant Skirving that the North 65 feet belonged to Tax Lot 4, and said Defendant agreed that said buildings might be permanently located at the place of removal under that belief.

“That at no time would the Plaintiffs have continued in possession of or maintained said buildings upon the North 65 feet as aforesaid, and at no time would the Defendant Skirving have agreed that Plaintiffs should remain in possession of said North 65 feet, if they, or either of them, had known where the true boundary line between Tax Lot 4 and the Defendant Skirving's property actually existed.

“That the houses, sheds, barns and each structure now upon said North 65 feet have been at all times considered as personality by the Plaintiffs and the Defendant Skirving; and that at the time of her sale of said property to the Defendants, Clarence A. Rees and wife, said structures

were not included in the sale and no consideration was given for them, or either of them. That the Defendants Rees and wife never at any time believed they were purchasing said structures, or either of them, having been advised at the time of their purchase that the buildings were no part of the property purchased. (Italics ours)

“XVIII.

“That notwithstanding the facts hereinabove set out, the Defendants, Clarence A. Rees and Evelyn E. Rees, his wife, on or about January 20, 1944, took possession of all and every one of the structures hereinabove mentioned, moved into the house and ejected the Plaintiffs’ tenants therefrom, *and in all respects converted said property to their own uses; and denied the use or possession of same to Plaintiffs and their tenants;* and continue to do so up to the present time, although the Plaintiffs collected rent thereon for January and February, 1944, and their tenants remained in possession of said houses during said period. (Italics ours)

“XIX.

“That the fair market value of the house and other structures upon the North 65 feet of the Defendant Skirving’s property so converted by the Defendants, Rees and wife, at the time of the conversion on or about January 20, 1944, was \$1,000.00.”

From the foregoing findings, the Superior Court made the following pertinent Conclusions of Law (R. 77):

“III.

“That this is an equitable action, and the court has the right to do equity between the parties,

once it has acquired jurisdiction of the parties and the causes of action.

"IV.

"That the Defendants, CLARANCE A. REES and EVELYN E. REES, his wife, have converted personal property belonging to the Plaintiffs, consisting of a house, shed, barn and other structures situated on the North 65 feet of the Defendants' property, which property was so located thereon by agreement of the Plaintiffs and Defendant Skirving, and was at all times considered as personal property in which the Defendant Skirving never at any time claimed an interest, and was not sold to the Defendants Rees and no consideration was paid by the Defendants Rees therefor.

"That the Defendants Rees and wife, have become unjustly and unlawfully enriched by their conversion of Plaintiffs' buildings in the amount of \$1,000.00, and Plaintiffs are entitled to judgment therefor. (Italics ours)

(c) The exhibits offered in evidence by appellants

Defendants offered as an exhibit in the Superior Court a certain letter written by their then attorney, M. L. Longfellow, in which they asserted ownership of the house, and demanded that plaintiffs immediately vacate the same (R. 64-65).

When the right to a discharge of the judgment debt was under consideration in the Bankruptcy Court, appellants themselves offered in evidence all of the above pleadings, findings and conclusions and the

Longfellow letter. They offered no oral testimony, but relied entirely upon the record (R. 8). They cannot now complain of error because the Referee also relied upon that record, or that the District Court erred in likewise relying upon it.

The facts, as found by the Superior Court, speak for themselves. The appellants knew when they bought the land from Cora J. Skirving that she did not own the buildings. They knew they were considered as personality and were not a part of the land. They paid no consideration for the buildings. They were told by Mrs. Skirving that she did not own them, and they freely admitted in their pleadings that they knew at the time of the sale the circumstances surrounding the severance of the buildings from the land.

The adjoining Tax Lot 4 they bought from King County for \$50.00. It would be absurd to believe that they thought they were buying any improvements for such a small amount. At no point in either their pleadings, their testimony or their evidence have they urged upon either of the three tribunals hearing the issues that any consideration was paid to King County for the buildings.

Yet they took possession of the buildings and ejected the appellees therefrom. Their acts were deliberate. The facts clearly establish a design upon their part to obtain possession of the buildings. They intended to take property which did not belong to them, and when they excluded appellees from the property they actually accomplished the conversion. That such a conversion is unlawful is irrefutable. The Referee could ar-

rive at no other conclusion (R. 13, 15, 17, 18, 19). Nor could the district judge (R. 24, 27).

Discussing the facts in his written decision, the Referee said:

“Of great and controlling importance in this case are the facts that the buildings belonging to the Jensens and converted by the Rees’ were personal property, had been severed from the realty in a lien foreclosure against ‘Doc’ Hamilton, and had been physically removed from the place they were originally constructed. * * * (R. 8)

“These circumstances and the fact that the bankrupts did not avail themselves of the privilege of taking the witness stand and explaining what motives they had or what possible justification they could have in converting to their own use the personal property of the judgment creditors, leaves the Findings of Fact and Conclusions of Law upon which the judgment is based unanswerable. * * *” (R. 8)

“In this case the Reeses did not come into possession of this personal property by the consent of the owner, nor by inadvertence. The Findings of Fact and Conclusions of Law above quoted negative any contention that when they bought the property they thought the buildings were attached thereto as realty and that they were, therefore, the owners thereof. They did not so testify and the evidence established that they designedly obtained possession of these buildings and converted them to their own use and, therefore, the judgment based upon said conversion is not dischargeable in bankruptcy.” (R. 13)

2. Does An Intentional Unlawful Conversion Come Within the Meaning of “Wilful and Malicious Injuries to the Person and Property of Another”?

The District Court aptly said:

“If the matter were before me as a matter of first impression and without restriction by judicial decisions of courts which bind me, I would have no great difficulty. * * * But I am bound and controlled by a forest of authority. The weight of authority is to the effect that those simple words ('wilful and malicious injuries to the person or property of another') include intentional conversion of the kind which Judge Ronald (of the Superior Court) in his findings determined occurred on the part of the bankrupts as against the property of Mr. and Mrs. Jensen.” * * * (R. 24-25)

(a) Intentional conversion is a wilful and malicious injury to the property of another.

To constitute a wilful and malicious injury to property, the conversion must have been with the intent to convert the same, knowing that the property was the property of another. It was not necessary to use the words “wilful and malicious” in the pleadings or in the judgment of the court if the facts upon the record and as found by the court constituted an intentional and deliberate appropriation of the property by the bankrupt for his own uses. No personal malice need be shown, but the wrongdoer will be held responsible for the legal effects of his acts.

This view has been held in many cases, a leading case being

Tinker v. Colwell, 193 U.S. 473.

Since this case has been time after time quoted from in the decisions involving construction of the words "wilful and malicious" injuries in bankruptcy cases, we quote at length as follows:

"In order to come within the meaning of a judgment for a wilful and malicious injury to person or property, it is not necessary that the cause of action be based upon a special malice so that without it the action could not be maintained. * * * A wilful disregard of whatever he knows to be his duty, an act which is against good morals and wrongful in and of itself, and which necessarily causes injury, and is done intentionally, may be said to be done wilfully and maliciously, so as to come within the exception.

* * *

"It is urged that the malice referred to in the exception is malice toward the individual personally, such as is meant, for instance, in a statute for maliciously injuring or destroying property, or for malicious mischief, where mere, intentional injury without malice toward the individual has been held by some courts not to be sufficient. *Commonwealth v. Williams*, 110 Mass. 401.

"We are not inclined to place such a narrow construction upon the language of the exception. We do not think the language used was intended to limit the exception in any such way. * * * It was an honest debtor and not a malicious wrong-doer that was to be discharged.

"There may be cases where the act has been performed without any particular malice toward the husband, but we are of opinion that, within the meaning of the exception, it is not necessary

that there should be this particular, and, so to speak, personal malevolence toward the husband, but that the act itself necessarily implies that degree of malice which is sufficient to bring the case within the exception stated in the statute. The act is wilful, of course, in the sense that it is intentional and voluntary, and we think that it is also malicious within the meaning of the statute.

"In *Bromage v. Prosser*, 4 Barn & Cres 247, which was an action of slander, Mr. Justice Bayley, among other things, said:

"‘Malice, in common acceptation, means ill will against a person, but in its legal sense it means a wrongful act, done intentionally, without just cause or excuse. If I give a perfect stranger a blow likely to produce death, I do it of malice, because I do it intentionally and without just cause or excuse. If I maim cattle, without knowing whose they are, if I poison a fishery, without knowing the owner, I do it of malice, because it is a wrongful act, and done intentionally. If I am arraigned of felony and wilfully stand mute, I am said to do it of malice, because it is intentional and without just cause or excuse. And if I traduce a man, whether I know him or not and whether I intend to do him an injury or not, I apprehend the law considers it as done of malice, because it is wrongful and intentional. It equally works an injury, whether I produce an injury or not.’"

"We cite the case as a good definition of the legal meaning of the word malice. The law will, as we think, imply that degree of malice in an act of the nature under consideration, which is sufficient to bring it within the exception mentioned."

In discussing another case of damages for seduction of a daughter, that court, quoting from *In re Freche*, 109 Fed. 620, said:

“From the nature of the case the act * * * which caused the injury was wilful, because it was voluntary. The act was unlawful, wrongful and tortuous, and, being wilfully done, it was, in law, malicious. It was malicious because the injurious consequences which followed the wrongful act were those which might naturally be expected to result from it, and which the defendant must be presumed to have had in mind when he committed the offense. “Malice” in law simply means a depraved inclination on the part of a person to disregard the rights of others, which intent is manifested by his injurious acts. While it may be true that in his unlawful act Freche was not actuated by hatred or revenge or passion towards the plaintiff, nevertheless, if he acted wantonly against what any man of reasonable intelligence must have known to be contrary to his duty, and purposely prejudicial and injurious to another, the law will imply malice * * * ”

“The judgment here mentioned comes, as we think, within the language of the statute reasonably construed * * * ”

The courts have universally held that an intentional conversion of the property of another amounts in law to wilfulness and malice. The leading and most quoted case on this subject is *McIntyre v. Kavanaugh*, 242 U.S. 138:

“In this case McIntyre & Co. were brokers. They received certain stock certificates owned by Kavanaugh to hold them as security for his indebtedness to them. Within a few weeks with-

out authority and his knowledge, they sold the stocks and appropriated the avails to their own use. The firm became bankrupt.

"Plaintiff, nevertheless, sued for damages for wrongful conversion, and it was argued that 'an examination of our several Bankruptcy Acts and consideration of purpose and history of the 1903 Amendment will show Congress never intended the words in question to include conversion.'

"We can find no sufficient reason for such a narrow construction. * * *

"It is not necessary that physical injury to property be inflicted to constitute wilful and malicious injury. Special malice against the owner of property need not exist.

"But depriving a person of his property, without authority is sufficient to show a wilful disregard of his duty and is sufficient to constitute wilful and malicious injury.

"The circumstances disclosed suffice to show a wilful and malicious injury to property for which plaintiff in error became and remains liable to respond in damages."

The case of *Bever v. Swecker*, 138 Ia. 728, 116 N.W. 704 (1908), is of special interest because it involved another kind of conversion more nearly like the conversion at bar. Cattle of plaintiff were converted by the bankrupt.

In this case the judgment creditor brought a garnishment proceeding to subject property to payment of his judgment. A motion was made to discharge the garnishment on the ground that the debt was dis-

charged by the bankruptcy. The motion was overruled and judgment was granted against the garnishee. Upon appeal the lower court was affirmed.

The question before the Supreme Court was a determination of the meaning of the words "wilful and malicious injuries to property." The court said:

"Was the judgment in this case for the unlawful and malicious injury to the property of plaintiff? This is the pivotal question in the case. That the act of Defendant in taking the cattle was unlawful there can be no question; but was it 'malicious' as the term is used in the Bankruptcy Act? The only showing in addition to that heretofore stated regarding the matter of Defendant's liability is that Plaintiff commenced suit to recover the value of the cattle which resulted in the judgment upon which the execution is-sued. * * *

"The only remaining inquiry is: 'Was the injury to the property "malicious" as that term is used in the Bankruptcy Act?' "

Adopting the language of *Christal v. Clisbe* (Mass.) 76 N.E. 11, the court said:

"It is scarcely necessary to say that the taking and carrying away of the property of another is an injury to that property * * * We are satisfied that the judgment in the case was for wilful and malicious injury to the property of Plaintiff * * * The claim need not be reduced to judgment. If it be merged in a judgment we go to the nature of the liability to determine the question of release.

"There is no doubt, we think, that the liability in the case was for wilful and malicious injury to property, as those terms are used in Bank-

ruptcy Act. The injury or wrong was just as malicious as an assault and battery upon the person would have been, and in such case it is universally held that the bankrupt is not released * * * Moreover, the liability was in tort and the tort could not be waived and the debt was not provable in the Bankruptcy proceedings."

The court said in *Greenfield v. Tucillo* (C.C.A. 2, 1942) 49 A.B.R. (N.S.) 529:

"The question is whether the liability to Greenfield was for 'wilful and malicious' injury. Such injuries have been defined by the Supreme Court as arising from an act involving a wilful disregard for what one knows to be his duty, an act which is against good morals and wrongful in and of itself, and which necessarily causes injury and is done intentionally."

In Remington on Bankruptcy, Vol. 7, 813, it is said:

"* * * actual malice is made out within the meaning of Sec. 17(a) * * * (2) where the act is shown to have been an intentional and wrongful act and without just cause or excuse. An actual physical injury to the subject matter of the property is not essential."

To like effect are the following well known cases involving many types of conversion:

Matter of Binsky, 24 A.B.R. 496 (conversion of collateral);

Matter of Gumbinsky, 8 F. Supp. 601 (conversion of money);

In re Keeler, 40 A.B.R. 231, 243 Fed. 770;
Covington v. Rosenbusch, 42 A.B.R. 400
 (conversion of wages);

In re Stenger, 49 A.B.R. 224 (conversion of insurance premiums);
Baker v. Bryant Fertilizer Co., 46 A.B.R. 579;
In re Nordlight, 22 A.B.R. 481;
Campbell v. Gates, 239 N.Y. 457;
Matter of Goldstein, 30 F. Supp. 443 (conversion of real property);
Van Epps v. Aufdemkamp, 32 P.(2d) 1116 (conversion of stock certificates);
Smith v. Ladrie, 129 Atl. 302 (conversion of flour);
In re Stark, 18 A.B.R. (N.S.) 278;
In re Franks, 17 A.B.R. (N.S.) 304;
In re Brier, 2 A.B.R. (N.S.) 756, 766;
Probst v. Jones, 247 N.W. 779 (conversion of a deed);
Woelfle v. Giles, 184 S.W.(2d) 177 (conversion of mortgaged property);
Frangos v. Frangos, 41 Atl.(2d) 416 (conversion of money);
Globe Indemnity Co. v. Granskar, 16 N.W. (2d) 437;
Matter of Buzas, 58 F. Supp. 717 (damage to land);
In re Blauweiss, 23 N.Y.S.(2d) 907 (conversion of emerald);
Weeks v. Streicher, 58 N.E.(2d) 415 (conversion of real property);
Knights Products Inc. v. Donnen Fuel Co., 20 N.Y.S.(2d) 135 (conversion of trust money);

Matter of Minsky, 46 F. Supp. 104 (inducing breach of contract);

Norby v. Cain, 176 S.E.(2d) 813.

In *Smith v. Ladrie*, *supra*, the court relied upon the following quotation from *Tnker v. Colwell*, *supra*:

“But when the conversion is the result of a deliberate and intentional disregard of another’s legal rights, it is a wilful and malicious injury to his property. It is wilful because it is voluntary (Webster’s New International Dictionary), and it is malicious, because it is intentional.”

In *Matter of Goldstein*, *supra*, the court said:

“I am forced to the conclusion that ‘unlawful and wilful are practically synonymous with ‘wilful and malicious,’ and that therefore the arrest on the civil process of petitioner was upon a debt not dischargeable in bankruptcy * * *.”

(b) Actual words of the statute need not be pleaded

Actual malice need not be pleaded or proved. The acts complained of need not be charged in the language of the statute. But the state court’s ruling on the nature of the liability as established by the judgment will be adopted.

In re Greene, 87 F.(2d) 951.

4 Words and Phrases, 2nd Series 1312, which succinctly states:

“The term ‘wilful and malicious’ as used in the bankruptcy act in question need not involve actual malice, as we usually think of that term. In fact, actual malice is seldom present in such cases. If an act, wrongful within itself, is done intentionally and in wilful disregard of what one knows

to be his duty, and which through necessity, causes an injury to another, it may be said, under the act, to be done wilfully and maliciously. Wilful and malicious injury, in the bankruptcy act, does not necessarily involve hatred or ill will as a state of mind, but arises from a wrongful act, done intentionally without just cause or excuse."

It is not necessary to plead the words "wilful or malicious." The court, *In re Northrup*, 265 Fed. 420 said:

"While the complaint does not expressly state that the conversion was wilfully done, still it must have been, if the defendant did what the complaint says; and hence the conversion was a wilful injury to the property of Taylor, and the claim, if sustained, on a trial of the action, would not be one discharged in bankruptcy.

"Not every conversion of property constitutes a wilful and malicious injury to property; but if a person knowingly and wilfully takes the property of another without the owner's consent, express or implied, and appropriates it to his own use, it is difficult to understand why the act so done does not constitute a wilful and malicious injury to the property of the person whose property is so taken and used."

Heaphy v. Kerr, 180 N.Y.S. 542;

Wood v. Fisk, 109 N.E. 177;

Kavanaugh v. McIntyre, supra;

Andrews v. Dresser (N.Y.) 108 N.E. 1088;

In re Werner, 88 F.(2d) 899, 33 A.B.R. (N.S.) 656.

With the foregoing wealth of authority to guide us, the conclusion is inescapable that appellants not only

physically converted the houses and structures of appellees, but that their conversion was wilful and malicious within the meaning of the bankruptcy act.

COMMENTS ON BRIEF OF APPELLANTS

1. Conversion of the Property of Appellees

On pages 4 to 8 of appellants' brief, they urge now for the first time that the question of conversion was never before the lower court, claiming that the pleadings did not raise the issue. However, the complaint clearly pleaded wrongful conversion of the buildings in paragraphs III, IV and V of the second cause of action, as well as the prayer for relief (R. 45, 46, 47). Moreover, except in their formal pleadings no denial was ever made either before the Superior Court or the referee, that they had converted the buildings. In fact, they admitted conversion, and in an effort to justify it, they even offered in evidence a letter from their then attorney, M. L. Longfellow. But the letter proved too much, for it demanded possession of the buildings from appellees, albeit on some unsure and elusive theory that they owned the same.

They further attempted to meet the issue of conversion in the lower court by offering their contract of purchase from Cora J. Skirving, which contained formal printed provisions, providing for the sale of appurtenances and keeping the buildings thereon insured. But the court found that the buildings were not included in the sale and no consideration was paid for them in the purchase price.

As if unconvinced of their own position, appellants

fall back upon the case of *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, seeking to bring the acts of their conversion within the well known category of those cases where the conversion involved no intent to take property knowing it to belong to another. We have no quarrel with that case, nor those which follow it, for the conversion there was innocent and technical, and contained none of the elements of wilfulness or malice interfused in the case at bar. Here was no "innocent misadventure of the bankrupts" (Appellants' Brief 18), but a craftily calculated design to obtain possession of appellees' buildings, knowing they had not purchased them and that they belonged to appellees.

We have already discussed in detail the cases upon which we rely, some of which appellants have cited on pages 20 and 21 of their brief. Appellants' attempt to distinguish them from the case at bar is unconvincing. They particularly mention *Tinker v. Colwell, supra*, and *In re Freche, supra*, on the ground that those leading cases which established the basic rule of law in conversion cases involved "quasi-criminal acts of bankruptcy as criminal conversation and seduction which import a wanton disregard for the rights of others in their very nature." It is significant, however, that the courts of all jurisdictions of the country have made no such distinction, but have universally followed the law laid down therein in cases involving every kind of tangible and intangible property, on the well grounded theory that the crux of the issue is the nature of the conversion rather than the nature of the property converted.

2. The Burden of Proof

On page 32 of appellants' brief, the court is told that the burden of proof is upon the judgment creditor to show that the liability comes within the exception of Section 17(a)(2), and that the referee shifted it to appellants.

Appellants ably assisted appellees in meeting the burden, for it was they who offered in evidence before the referee the pleadings, the findings of fact and conclusions of law and the exhibits of the Superior Court action (R. 65, 79). They cannot complain now that the Bankruptcy Court admitted them, and that appellees used them to prove their case at the hearing on their objections to the discharge of their judgment debt. At no stage of the proceedings did the burden shift. It became fixed by the adoption of the Superior Court record as the record in the Bankruptcy Court. All litigating parties relied upon that record, and the facts it contained.

Wilfulness and malice inhere in the legal conclusions which the courts attach to the acts already proved and now of record in the Bankruptcy Court. The burden has now expended itself; and the only question before the referee, the District Court and this court is the applicability of the rule to the facts proven and recorded.

Appellants entirely misinterpreted the language of the referee to the effect that the appellants did not avail themselves of the privilege of taking the witness stand and explaining their motives in converting appellees' property. The referee merely meant that since

no oral testimony was offered by appellants to rebut the findings and conclusions of the lower court, he had no other alternative than to decide the question upon the record and the circumstances of the conversion as shown therein. The question of burden of proof was not involved in his statement at all (R. 6. 8).

The cases cited on page 33 of appellants' brief are not in point for the reason that those cases were not tried on a record previously made in another court. The question involved there arose in the original trial.

3. Appellants Claim They Were Confused Regarding Their Rights

In defending against the referee's and the District Court's decision holding that the legal effect of appellants' acts of conversion were wilful and malicious, on page 23 of appellants' brief, they say that their conduct was consistent with a state of innocent confusion as to their right to appellees' buildings. They showed no evidence of confusion, however, for they proceeded cautiously, engaged a lawyer, and demanded possession of the buildings without having sought a legal tribunal to have their rights determined. If there was confusion in their minds as to the rightful owner, then they did, by admitted fact, act in wanton disregard for appellees' rights, and the wilful and malicious character of the conversion became complete.

The inconsistency of appellants' vacillating positions with reference to their right to the buildings, as stated in pages 24 and 25 of their brief, leaves their arguments unworthy of attention. At one point they state they had doubt about the location of the build-

ings, but two paragraphs later they state they were justified in believing that they bought the buildings as a part of the Skirving property. Suffice it to say, the Superior Court found that they *knew* the buildings were not included in that sale (R. 74, 75).

4. The Stricken Paragraph in the Lower Court's Findings

In appellants' struggle to justify their conversion, they propose on page 25 of their brief a further and yet more inconsistent and irrational argument to the effect that appellants "asserted a well-founded claim to the structures" because there was a discrepancy in the boundary line between Tax Lot 4 and the Skirving land. Actually, however, the location of the exact boundary line between the two properties had nothing to do with appellants' acquisition of the buildings, for the simple reason that they knew they were not included in the sale. They paid only \$50.00 for Tax Lot 4, consisting of one and a half acres. They paid only \$1900.00 for the Skirving land, consisting of 22 acres. It is ridiculous to argue or assume that any structures were included in either purchase.

Yet, appellants on pages 12 and 27 of their brief have laid great stress upon the fact that the lower court struck out a sentence in the findings to the effect that at the time of the purchase of Tax Lot 4 the appellants knew it was worth more than they paid for it, and also knew that appellees were ignorant of the proceedings pending in the county treasurer's office for the purchase (R. 72).

After all, these findings were immaterial to find-

ing of intentional conversion of the buildings. The actual foundation for the conversion was laid during the negotiations for the purchase of the *Skirving* property, not at the time of the negotiations for the purchase of *Tax Lot 4*.

On page 27 of appellants' brief they complain that the referee commented in his decision that it was logical to believe that when appellants negotiated for the purchase of Tax Lot 4 they believed they were buying vacant land, and not land and buildings, because of the great variance between the \$50 bid and payment for the tax lot and the \$1000 value on the buildings alone (R. 8). However, this comment was a natural deduction from the facts; and the comment resulted in giving appellants the benefit of honesty and fair dealing with the treasurer, to which they were not exactly entitled, in view of the Longfellow letter (R. 64) written on the heels of the purchase asserting that they were entitled to the buildings, either because they were located on Tax Lot 4 or on the *Skirving* property.

By no stretch of the imagination can appellants claim, as they do, on pages 27 and 28 of their brief that the referee rested his decision on the stricken words of the lower court, for he had the whole record before him, replete with statements in the pleadings of all the litigating parties and the findings and conclusions, justifying his decision that appellants had intentionally converted buildings knowing they belonged to another.

On page 29 of appellants' brief they charge that the

referee failed to grasp the facts of the controversy because he stated in his decision (R. 15):

“* * * (the structures) * * * were considered and known to all the parties, including the bankrupts, to be the personal property of the judgment creditors * * *.”

What other conclusion could any intelligent person reach?

They acquired the Skirving property on January 13, 1944 (R. 63).

They demanded possession of the buildings from appellants the next day, January 14, 1944 (R. 71).

They did not acquire Tax Lot 4 until January 20, 1944 (R. 71), six days after the demand has been made.

Their alacrity in converting the property clearly implies that they knew appellees owned it.

If they had not known the property belonged to the appellees, why did they demand possession from *them*?

Besides, the pleadings and findings show that appellants were negotiating for both parcels of property at the same time, and they were intimately acquainted with appellees' ownership of the buildings during all the negotiations. The lower court made a finding, without objection from them, that appellees had collected rentals on the buildings for the two months following appellants' purchase of both parcels of land (R. 76).

5. The Referee's Inadvertence in Describing Property

On pages 30 and 31 of appellants' brief, appellants lay great stress upon a purely typographical error in a portion of the referee's decision, in which he stated that the buildings had been physically removed from the place they were originally constructed "and probably mistakenly placed upon Tax Lot 4" (R. 8).

The referee had a clear concept of all the facts. His keen analysis and understanding of the issues is indicated throughout his entire written opinion. It is apparent that he meant to say "and probably mistakenly placed upon another portion of the Skirving property." A reasonable, fair-minded perusal of the decision would lead to no other conclusion. It is not worthy of the dignity of the court to pounce upon a patently inadvertent error and attempt to make it a major argument in the case.

It is significant that appellants took no notice of the inadvertence when the findings of fact and conclusions of law were presented to the referee, nor did they call it to the attention of the District Court upon the review.

6. The District Court's Decision

By subtracting a sentence here and there from the district court's decision, appellants in their brief on page 35 perceive a disposition in the court to disagree with the referee. This they claim is grounds for reversal.

When the decision is taken as a whole, the total is

in complete accord with the referee. The court said (R. 24) :

"I have given serious consideration to the records of the entire bankruptcy matter and to the records as admitted in evidence in the Superior Court action upon which the judgment of Mr. and Mrs. Jensen was based. I have also given serious consideration to the respective briefs of the parties and been aided by the oral argument which was presented to me in August. * * *

"With no decisions to guide my course, I am inclined to believe that I would consider the language as not protecting the judgment of Mr. and Mrs. Jensen. But I am bound and controlled by a forest of authority. The weight of authority is to the effect that those simple words ('wilful and malicious injuries to the person or property of another' appearing in the bankruptcy statute) include intentional conversion of the kind which Judge Ronald (the Superior Court judge) in his findings determined occurred on the part of the bankrupts as against the property of Mr. and Mrs. Jensen. As a result, I feel that in the light of the authorities which control me I must sustain, and therefore I do sustain the decision of the referee. (R. 25)

"The opinion of the referee as found in the files displays that sufficient study of authorities and consideration of the findings of the Superior Court judge as make unnecessary any substantial discourse by me. (R. 25) * * *

"I feel I have no right to go further. I would not be justified in overruling the referee by virtue of the feeling that I have that were there no decisions controlling me that my opinion might

be different. I can and will say that I am not absolutely certain that the referee was correct. *However, the records here, the arguments and the authorities sufficiently indicate that he is correct and that I would have no right to reverse his conclusions.* I am not indicating that my mind is evenly balanced as to whether or not the referee is correct. Even in that event I take it that I should allow his ruling to stand. I will go further and say that I think it considerably more probable that he is right than that he is mistaken. So, of course, his decision is sustained." (R. 27) (Italics ours)

The very language of the court is a complete answer to the cases quoted on page 37 of appellants' brief. It was the prerogative of the District Court to give whatever weight he deemed justified to the referee's decision upon review. The fact that he resolved the points of law and the facts so as to reach the same result does not indicate he accorded excessive weight to the referee's findings; and his own statements above quoted from his oral decision refutes the implication that he felt bound to merely follow the referee's decision.

CONCLUSION

Upon the facts as pleaded and proved and upon the record voluntarily submitted in evidence to the Bankruptcy Court by the appellants themselves, the bankrupts intentionally and unlawfully converted the property of the judgment creditors.

From the principles laid down above and the great volume and variety of cases decided in many jurisdic-

tions, the only conclusion which can be reached is that the judgment debt here falls within the exceptions of Sec. 17(a)(2) of the bankruptcy act, and is not discharged by the bankruptcy of appellants.

The District Court's order sustaining the referee's decision to this effect should be affirmed.

Respectfully submitted,

LADY WILLIE FORBUS,

Attorney for Appellees.

May 5, 1948.

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FOR THE NINTH CIRCUIT

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Appellants,
vs.
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APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WASHINGTON,
NORTHERN DIVISION

REPLY BRIEF OF APPELLANTS

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MAY 18 1941

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TABLE OF CASES

| | <i>Page</i> |
|---|------------------|
| <i>Baker v. Bryant Fertilizer Co.</i> , 271 Fed. 473, 46 A.B.R. 579 (C.C.A. 4, 1921) | 8 |
| <i>Bever v. Swecker</i> , 138 Ia. 728, 116 N.W. 704 (1908) | 6 |
| <i>Blauweiss, In re</i> , 23 N.Y.S.(2d) 907 (City Ct. of N.Y. Queens County 1940) | 9 |
| <i>Binsky, Matter of</i> , 24 A.B.R. (N.S.) 496 (D.C. S.D. N.Y. 1934) | 7 |
| <i>Brown v. Garey</i> , 267 N.Y. 167, 196 N.E. 12 (1935) | 3 |
| <i>Buzas, Matter of</i> , 58 F. Supp. 717 (D.C. N.D. Col. 1944) | 9 |
| <i>Continental Live Stock Co. v. King</i> , 283 Mich. 495, 278 N.W. 661 (1938) | 9 |
| <i>Covington v. Rosenbusch</i> , 42 A.B.R. 400 (S.C. Ga. 1918) | 7 |
| <i>Davis v. Aetna Acceptance Co.</i> , 293 U.S. 328, 55 Sup. Ct. 151 (1934) | 2, 4, 5, 6, 8, 9 |
| <i>Franks, In re</i> , 17 A.B.R. (N.S.) 304 (D.C. W.D. Pa. 1931) | 8 |
| <i>Freche, In re</i> (D.C. N.J.) 109 Fed. 620 (1901) | 3, 5 |
| <i>Globe Indemnity Co. v. Gronskov</i> , 246 Wis. 87, 16 N.W.(2d) 437 (1944) | 10 |
| <i>Goldstein, Ex parte</i> , 30 F. Supp. 443 (D.C. S.D. N.Y. 1939) | 8 |
| <i>Greenfield v. Tucillo</i> , 192 F.(2d) 854, 49 A.B.R. (N.S.) 529, (C.C.A. 2, 1942) | 6 |
| <i>Gumbinsky, Matter of</i> , 8 F. Supp. 601, 26 A.B.R. (N.S.) 436 (D.C. W.D. N.Y. 1934) | 7 |
| <i>Keeler, In re</i> , 243 Fed. 770, 40 A.B.R. 231 (D.C. N.D. N.Y. 1917) | 7 |
| <i>McIntyre v. Kavanaugh</i> , 242 U.S. 138, 37 Sup. Ct. 38 (1916) | 4, 5, 8, 10 |
| <i>Minsky, Matter of</i> , 46 F. Supp. 104 (D.C. N.Y. 1942) | 10 |
| <i>Nordlight, In re</i> , 3 F. Supp. 486, 22 A.B.R. (N.S.) 481 (D.C. S.D. N.Y. 1933) | 7 |
| <i>Probst v. Jones</i> , 247 N.W. 779 | 9 |

TABLE OF CASES

| | <i>Page</i> |
|--|-------------|
| <i>Smith v. Ladrie</i> , 129 Atl. 302 (S.C. Vt. 1925)..... | 7 |
| <i>Stark, In re</i> , 18 A.B.R. (N.S.) 278..... | 10 |
| <i>Stenger, In re</i> , 283 Fed. 419, 49 A.B.R. 224 (D.C. Mich. 1922) | 8 |
| <i>Tinker v. Colwell</i> , 193 U.S. 473, 24 Sup. Ct. 505 (1904) | 3, 5 |
| <i>Van Eps v. Aufdemkamp</i> , 32 P.(2d) 1116 (D.C. of App., 2d Dist. Cal. 1934)..... | 7 |
| <i>Weeks v. Streicher</i> , 58 N.E.(2d) 415 (Ct. of App. of Ohio, Lucas County 1943)..... | 10 |
| <i>Woelfle v. Giles</i> , 184 S.W.(2d) 177 (S.C. Tenn. 1945) | 9, 10 |

STATUTES

| | |
|----------------------------------|------|
| U.S.C., Title 11, §17(a)(2)..... | 4, 8 |
|----------------------------------|------|

**IN THE
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APPEAL FROM THE UNITED STATES DISTRICT COURT
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REPLY BRIEF OF APPELLANTS

In reply to the answering brief of appellees, we will more fully elaborate on the law as applicable to this case, and then show that the conversion involved here was not a "wilful and malicious injury to property" within the purview of the Bankruptcy Act.

The burden of proving that the conversion was a wilful and malicious injury to property and that therefore the judgment based upon that conversion was not discharged in bankruptcy is upon the appellees. The authority for this proposition was set forth in appellants' brief. In their comment upon the question of the burden of proof, the appellees do not deny or in any way present authority contrary to this proposition. We take it that it is then admitted that

our statement of the law on this point is correct and that no further comment is necessary.

The appellees would have us believe that an "intentional conversion is a wilful and malicious injury to the property of another." This is not the law! We have cited in appellants' brief the leading case of *Davis v. Aetna Acceptance Co.*, 293 U. S. 328, 331, 332, 333, 55 Sup. Ct. 151 (1934) wherein Mr. Justice Cardozo, speaking for the Supreme Court, said:

"There is no doubt that an act of conversion, if wilful and malicious, is an injury to property within the scope of this exception. * * * But a wilful and malicious injury does not follow as of course from every act of conversion, without reference to circumstances. * * * The discharge will prevail as against a showing of conversion without aggravated features."

This case is the latest expression by the Supreme Court of the United States of the law with respect to the dischargeability in bankruptcy of a liability arising from a conversion—the law which covers the instant case. We have in addition cited in appellants' brief many more cases which follow the *Davis* case, *supra*. All of these cases are authority for the proposition that a conversion without aggravated circumstances is not a wilful and malicious injury; they contrast the innocent and technical conversion with those which are wilful and malicious. The fact that a conversation is intentional does not *per se* make it wilful and malicious. Every act which constitutes a conversion must be intentional, otherwise it would never be done. The test should be—was the intent

wrongful, wilful, and malicious? The case of *Brown v. Garey*, 267 N.Y. 167, 196 N.E. 12 (1935), cited in appellants' brief, states:

"Since a wrongful intent is not an essential element of conversion, an act of dominion done under mistake or misapprehension, and without conscious intent to violate right or authority, may yet be a conversion; but it is not a wilful and malicious conversion."

The many cases cited by the appellants' in their brief are not discussed or distinguished by the appellees in their brief. We shall, therefore, make no further comment on these cases, but proceed with an analysis of the cases presented by the appellees in their brief.

The appellees rely on *Tinker v. Colwell*, 193 U.S. 473, 24 Sup. Ct. 505 (1904), *In re Freche* (D.C. N.J.) 109 Fed. 620 (1901), and many others later to be discussed. These cases, which are the "forest of authority" erroneously relied upon by the Referee in Bankruptcy and by the District Court, are not authority for the narrow point of law involved in the instant case.

In Re Freche, supra, involved the seduction by the judgment debtor of the plaintiff's daughter. *Tinker v. Colwell, supra*, involved the criminal conversation of the judgment debtor with the plaintiff's wife. In both cases, the main issue was whether or not actual malice toward the plaintiff must be shown to bring the injury under the scope of Section 17 (a) (2) excepting the judgment from the discharge of the Bankruptcy Act. In both cases, it was held that because of the unconscionable character of the act involved, malice toward the plaintiff would be inferred. It is

interesting to note that a subsequent amendment to the Bankruptcy Act now specifically excepts from the operation of a discharge in bankruptcy "liabilities for the seduction of an unmarried female or for criminal conversation." (Bankruptcy Act, Sec. 17 (a) (2).)

The question of whether or not a judgment for conversion was a "liability for wilful and malicious injury to property" was first presented to the Supreme Court of the United States in *McIntyre v. Kavanaugh*, 242 U.S. 138, 37 Sup. Ct. 38 (1916). In that case, the Supreme Court held that a finding by the lower Court of "wilful and malicious injury to property" brought this judgment for conversion within the exception to the discharge of the Bankruptcy Act. An examination of the cases following the *McIntyre* case, *supra*, seems to indicate that some courts construed the mandate of that case to except all liabilities arising from a conversion from the operation of a discharge in bankruptcy. It was, no doubt, to correct this false impression and to prevent judicial inroads into the protection of debtors which the legislature intended in the enactment of the Bankruptcy Act that the Supreme Court of the United States heard the *Davis* case, *supra*, and announced that a "wilful and malicious injury does not follow as of course from every act of conversion." We contend that since the instant case involves a liability arising from a conversion, the law applicable thereto is the *Davis* case, *supra*, and the cases decided in reliance thereon, and therefore that the law on the issue here involved is this: The fact of a conversion is not conclusive. We

must look to the record behind the judgment for the conversion. If the record shows a wilful and malicious injury to property, then the judgment will not be discharged, but if the record fails to show a wilful and malicious injury, and it must be remembered that the burden is on the judgment creditor to show wilfulness and malice, then the debt must be discharged.

Let us consider the cases which appellees cite to support their argument. First cited are *Tinker v. Colwell, supra*, *In re Freche, supra*, and *McIntyre v. Kavanaugh, supra*. The latter case, as qualified by the *Davis* case, *supra*, is now the law of the land with respect to the issue here involved. Since the *Tinker* and *Freche* cases, *supra*, are not similar to the instant case on their facts, those cases are not controlling, and when as here we have a pronouncement by the United States Supreme Court in a case "on all fours" with the instant case, authority from analogous cases such as *Tinker v. Colwell* and *In re Freche, supra*, should be irrelevant.

The case of *McIntyre v. Kavanaugh, supra*, was distinguished by Mr. Justice Cardoza when he said in the *Davis* case, *supra*, that:

"There is no doubt that an act of conversion, if wilful and malicious, is an injury to property within the scope of this exception. Such a case was *McIntyre v. Kavanaugh*, 242 U.S. 138, where the wrong was unexcused and wanton."

In that case (*McIntyre*) the record showed that the trial court had found that the judgment debtor had "committed wilful and malicious injury to the

property of the plaintiff." No such finding was present in the *Davis* case, *supra*, or in the instant case. Because of that factual difference, Mr. Justice Cardoza was able to distinguish the two cases.

Appellee next considers *Bever v. Swecker*, 138 Ia. 728, 116 N.W. 704 (1908). This authority antedates the leading case on this issue, the *Davis* case, *supra*, by 26 years. But more important, a close inspection of the case will show that the facts are not similar to the instant case. The Supreme Court of Iowa stated in its opinion:

"The action of trover proceeded on the fiction that the defendant found the property and thereafter converted it to his own use, and generally was brought where the defendant came into possession of the property rightfully. * * *

"The action of trespass, involved the idea of the violation of a possessory right, as well as forceful damage."

"The action which resulted in the judgment in this case was not case of *trover*, but *purely trespass*. * * *" (Italics ours.)

Thus the Supreme Court did not regard this as a judgment for conversion, but purely trespass. This authority should not be of great weight here where the judgment was for conversion.

Greenfield v. Tucillo, 192 F.(2d) 854, 49 A.B.R. (N.S.) 529, (C.C.A 2, 1942) cited by appellees involved the issue of whether or not a judgment against the debtor for negligent driving was dischargeable in bankruptcy. Judge Augustus Hand, speaking for the court said:

"It is true that the bankrupt was, on his own confession, convicted of violating * * * (Penal Law) * * * by operating his automobile 'in a reckless or culpably negligent manner.' But this is not conclusive proof that he had incurred civil liability to the objecting creditor for 'wilful and malicious injuries. * * *'

"Under the circumstances disclosed we cannot say whether the claims might not be barred by a discharge. * * * We think that the issues of fact should be tried out in the state court after the determination of the discharge."

This case is not authority that should control in the instant case because the facts are entirely different. Further, because the record failed to show with sufficient clarity circumstances from which a "wilful and malicious injury" could be predicated, the case was sent back to the trial court for a determination of this issue whenever the discharge should be pleaded to prevent enforcement of the judgment.

The brief of appellees continues with the "following well known cases involving many types of conversion."

An examination of *Matter of Binsky*, 24 A.B.R. (N.S.) 496 (D.C. S.D. N.Y. 1934), *Matter of Gumbinsky*, 8 F. Supp. 601, 26 A.B.R. (N.S.) 436 (D.C. W.D. N.Y. 1934), *In re Keeler*, 243 Fed. 770, 40 A.B.R. 231 (D.C. N.D. N.Y. 1917), *Covington v. Rosenbusch*, 42 A.B.R. 400 (S.C. Ga. 1918), *In re Nordlight*, 3 F. Supp. 486, 22 A.B.R. (N.S.) 481 (D.C. S.D. N.Y. 1933), *Van Eps v. Aufdemkamp*, 32 P.(2d) 1116 (D.C. of App., 2d Dist. Cal. 1934), *Smith v. Ladrie*, 129 Atl. 302 (S.C. Vt. 1925), and *In re*

Franks, 17 A.B.R. (N.S.) 304 (D.C. W.D. Pa. 1931), indicates that they all rely heavily upon the *McIntyre* case, *supra*, that a conversion can be a wilful and malicious injury to property within the purview of Section 17 (a)(2) of the Bankruptcy Act, without a full discussion of the circumstances surrounding the conversion. As we have earlier suggested, this practice by the courts was no doubt an important factor which caused the Supreme Court of the United States to review the whole question and qualify the *McIntyre* case, *supra*, by the doctrine of the *Davis* case, *supra*. The above cited cases are not of great importance following this latter case.

Other cases cited by the appellees give a fuller discussion of the issue here involved. *In re Stenger*, 283 Fed. 419, 49 A.B.R. 224 (D.C. Mich. 1922) involved a judgment debtor who had converted funds belonging to the insurance company which he represented—a taking which was felonious in nature. That fact should distinguish those circumstances from the instant case. Similarly, in *Baker v. Bryant Fertilizer Co.*, 271 Fed. 473, 46 A.B.R. 579 (C.C.A. 4 1921), the judgment debtor had used funds which he collected on his principal's account for cotton speculation. Here again we have a deliberate conversion against the known right of the principal to receive immediate payment.

In the case of *Ex parte Goldstein*, 30 F. Supp. 443 (D.C. S.D. N.Y. 1939) a finding of "unlawful and wilful" injury to the property of plaintiff was held to be a "wilful and malicious" injury to property within the scope of the Bankruptcy Act, Sec. 17 (a)(2). The

court held that the record from the trial court on this issue was binding. So also was *Matter of Buzas*, 58 F. Supp. 717 (D.C. N.D. Col. 1944) and *In re Blauweiss*, 23 N.Y.S.(2d) 907 (City Ct. of N.Y. Queens County 1940) where findings tantamount to a wilful and malicious injury were made by the trial court. The record in the instant case shows a finding of conversion—no aggravated features are mentioned. These cited cases are not applicable here because of this factual difference.

Probst v. Jones, 247 N.W. 779, is cited by the appellees. A later Michigan case, *Continental Live Stock Co. v. King*, 283 Mich. 495, 278 N.W. 661 (1938) relying upon the *Davis* case, *supra*, as its authority states:

“Appellant in support of its contention that the sale of its property by defendant in the instant case constituted a wilful and malicious injury within the terms of the bankruptcy statute cites and relies upon *Probst v. Jones*, 262 Mich. 678, 247 N.W. 779. However it must be borne in mind that the court found in the cited case that ‘defendant did not act in good faith.’ The finding in the instant case is directly to the contrary, and in consequence thereof the law of the *Probst* case is not here applicable.”

Since there is no finding of bad faith in the instant case, the *Probst* case, *supra*, should be likewise inapplicable here.

In *Woelfle v. Giles*, 184 S.W.(2d) 177 (S.C. Tenn. 1945), cited by appellees, the court relying upon the *Davis* case, *supra*, held that the judgment for conversion was dischargeable in bankruptcy because it

was "innocent and technical" to be distinguished from the *McIntyre* case, *supra*, where the conversion was so "unexcused and wanton" that it was clearly criminal. There is nothing in the *Woelfle* case, *supra*, inconsistent with the status of the law for which appellants are contending.

Appellees also cite *In re Stark*, 18 A.B.R. (N.S.) 278, *Globe Indemnity Co. v. Gronskov*, 246 Wis. 87 16 N.W.(2d) 437 (1944), *Weeks v. Streicher*, 58 N.E.(2d) 415 (Ct. of App. of Ohio, Lucas County 1943), and *Matter of Minsky*, 46 F. Supp. 104 (D.C. N.Y. 1942). Since these cases do not involve a conversion, as authority for the instant case they are not in point.

A careful examination of all the cases cited by appellees shows no authority which indicates that the status of the law on this issue is different from that set forth by appellants. If we may repeat, the law applicable here is this: A wilful and malicious injury does not follow as of course from every act of conversion without reference to the circumstances. To determine whether or not there is a wilful and malicious injury, resort must be had to the record. And the burden rests upon the appellee to show wilfulness and malice.

Turning now to a consideration of the circumstances of the conversion in the instant case to determine whether or not it was a "wilful and malicious" injury to property, we are, as a matter of law, confined to a consideration of those circumstances as presented by the record from the trial court.

Examining first the conclusions of law of the trial court we find: "That the defendants, Clarence A. Rees and Evelyn E. Rees, his wife, have *converted* personal property. * * *" (Italics ours) No mention is made of a wilful or unlawful or a malicious conversion. We must then look further to the pleadings and to the Findings of Fact to see if we find circumstances upon which to predicate wilfulness and malice.

It is contended by appellees in their argument that "the issue of unlawful, intentional conversion was placed squarely before the court" by the allegations of the second cause of action in appellees' Amended Complaint. The appellees' second cause of action alleged facts calculated to show adverse possession of the north 65 feet of the Skirving property for the prescriptive period by the appellees. As a part of this second cause, and the only part that could conceivably be the pleading of the issue of conversion which appellees contend appears in their complaint, the appellees allege that the improvements on the land were no part of the consideration paid for the Skirving property. They further allege that they have been wrongfully denied the use and income of the property—referring to the realty that they described previously to which realty they want title quieted in the appellees by reason of their adverse possession. This contention that they have by these allegations stated a cause of action for conversion is without merit. But even if it does allege a conversion, there is no allegation of wilfulness and malice and more important, no facts appear in the record upon

which such a finding of wilfulness and malice can be predicated.

Appellees argue that the allegations set forth in the preceding paragraph were admitted by the appellants. The record does not so indicate! The appellants alleged by way of an affirmative defense that a sale of the Skirving property "was consummated, the property being described by a metes and bounds description and *including appurtenances*." This allegation is a denial of appellees' allegation that "said improvements were no part of the consideration of said sale." With respect to appellees' contention that they have been wrongfully denied the use of their property, the appellants claimed both tracts as owners of the fee. The trial court recognized this as a proper claim when it refused to quiet title in appellees to any of the realty involved in the suit below. This allegation of the purchase of the appurtenances and an assertion of their, appellants', ownership of the land and appurtenances is certainly a denial of appellees' allegations.

When the trial court denied the appellees' claim to tax lot 4 and to the north 65 feet of the Skirving property and then went on from there to announce the conversion and judgment therefore, the appellants were completely surprised. The real estate contract between Cora Skirving and appellants (R. 61-63) upon which appellants based their claim to the Skirving property refers to the buildings (for insurance purposes) and then goes on to include the appurtenances. The finding of the trial court that:

"* * * at the time of her sale of said property to the defendants, Clarence A. Rees and wife, said structures were not included in the sale and no consideration was given for them, or either of them. That the defendants Rees and wife never at any time believe they were purchasing said structures, or either of them, having been advised at the time of their purchase that the buildings were no part of the property purchased."

is in direct contradiction to the above mentioned contract of sale reduced to and evidenced by the writing introduced into the record. This point is made, not to criticize the trial court for what seems to be an unwarranted conclusion, but to show that the conduct of the appellants in asserting ownership to land and appurtenances under a contract for the purchase of same was eminently reasonable, that such conduct was not wilful or malicious within the meaning of the Bankruptcy Act.

Examining the Findings of Fact to see what light they throw on the issue of a wilful and malicious injury we see that the trial court found, inter alia, the following pertinent facts:

"That at said time it was the general belief of both plaintiffs (appellees) and the defendant Skirving that the north 65 feet belonged to tax Lot 4, and said defendant agreed that said buildings might be permanently located at the place of removal under that belief.

"* * * and that at the time of her sale of said property to the defendants, Clarence A. Rees and wife, said structures were not included in the sale and no consideration was

given for them, or either of them. That the defendants Rees and wife never at any time believed they were purchasing said structures, or either of them, having been advised at the time of their purchase that the buildings were no part of the property purchased."

Appellants are by these findings charged with notice that the appurtenances were not conveyed with the deed to the Skirving property despite the fact that the contract of sale purported to convey the appurtenances. Yet these findings do not, nor does any other finding, show that the appellants knew that they did not own the appurtenances. As appellants stated in their brief, it was the belief of all parties to this litigation that the buildings were on Tax lot 4. There is no finding that appellants knew that the buildings were on the Skirving property. There is no finding that the appellants could not have reasonably believed that the buildings were on Tax lot 4; further the trial court specifically refused to find that "at the time of the purchase of said property the defendants Rees and wife knew the value of said property was greatly in excess of the amount paid." There is, then, nothing in the record inconsistent with the theory that the appellants purchased Tax lot 4 believing that the buildings were located thereon and that the assertion of ownership to the buildings was because of the reasonable belief that they owned them.

It is easy by hindsight, when the spotlight of investigation has been put upon a particular set of circumstances during the course of litigation, to grasp

at particular events and say: "They point to wilfulness and malice." But the proper question to which our minds here should be addressed is this: In the light of the circumstances attending the assertion by the appellants of their ownership of the land and appurtenances here in question, was this act done under the belief that they owned said appurtenances, which belief was eminently reasonable in view of the situation as it was then presented to them, or was it a wilful and malicious taking of property which they well knew they did not own?

Let us set forth the circumstances attending the conversion here in question. The appellants desired to purchase the tract of land consisting of Tax lot 4 and the Skirving property. When this purchase was arranged for, appellants notified (R. 64-65) the appellees to vacate Tax lot 4. In this notice (R. 64-65), it was stated:

"There is a dwelling house located in part, possibly, upon this property, but Mr. Rees has purchased other real estate joining this, and consequently is entitled to the dwelling house regardless of whether the same is located upon the real estate hereinabove described, or upon the other tract of real estate which has been purchased by Mr. Rees."

Shortly thereafter, appellees commenced a suit against the appellants to quiet title in appellees to Tax lot 4 on the ground of equitable frustration; this suit was commenced because they no doubt believed that the buildings were on Tax lot 4. If they so believed, how then can they argue that it was un-

reasonable for the appellants to believe that the buildings were on Tax lot 4 and that they, appellants, had received the buildings with the conveyance from King County? As before stated, the trial court by refusing to make a finding tantamount to knowledge that the buildings were not conveyed with the deed to Tax lot 4, admits the reasonableness of appellants' belief in this respect.

The next step came after appellants discovered by means of a survey that the buildings were in fact upon the Skirving property. Thereupon the appellees amended their complaint to include a second cause of action alleging facts calculated to show adverse possession by appellees of the north 65 feet of the Skirving property. Appellees were still proceeding, apparently, on the theory that the buildings are fixtures and go with the land. It was after the trial court had refused to quiet title in the appellees to either tract that they, appellees, met the fortuitous circumstance which has continued this litigation. The trial court found a conversion! Then the appellees go back to their pleadings to try to show that they have always considered the appurtenances as personalty. Appellees are now trying to show, when we have the benefit of the trial court's decision before us, that the act of the appellants, in asserting a claim to property which they reasonably believed was their own, was a wilful and malicious injury to property. They point out several circumstances which, they contend, show a wilful and intentional conversion. In our opinion, they have pointed to nothing in the record which is inconsistent with our contention that

the appellants were here acting in pursuance of a property right which they honestly and reasonably believed they had.

We believe that a comparison of the facts of this case with those of the cases cited in appellants' brief, cases which appellees have tried neither to refute nor to distinguish, will lead the court to conclude, as we do, that the record here does not show a wilful and malicious injury to property which excepts this liability from the operation of discharge in bankruptcy.

We content therefore that the appellees have not met their burden of proving this act to be a wilful and malicious injury to property.

Respectfully submitted,

COLVIN & WILLIAMS,
Attorneys for Appellants.

DAVID J. WILLIAMS,
MARY E. BURRUS,
of Counsel.

Central Building,
Seattle 4, Washington.

United States
Circuit Court of Appeals
for the Ninth Circuit

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, Copartners,
Doing Business Under the Fictitious Firm
Name and Style of Technical Porcelain &
Chinaware Company,

Appellants,

vs.

MERCHANTS FIRE ASSURANCE CORPORATION OF NEW YORK, a Corporation,

Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States
for the Northern District of California,
Southern Division

FILED

MAR 1 - 1948

PAUL P. O'BRIEN,
CLERK

No. 11831

United States
Circuit Court of Appeals
For the Ninth Circuit.

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, Copartners,
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INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

| | PAGE |
|---|------|
| Appeal: | |
| Appellants' Designation of Portions of Record, Proceedings and Evidence to be Contained in Record on..... | 36 |
| Appellants' Statement of Points Relied Upon on | 32 |
| Appellants' Statement of Points (CCA) Relied Upon on..... | 81 |
| Certificate of Clerk to Transcript of Record on..... | 38 |
| Notice of | 31 |
| Stipulation as to Reporter's Transcript on. | 34 |
| Answer to Complaint..... | 8 |
| Appellants' Designation of Parts of Record Necessary for Consideration and to Be Printed | 78 |
| Appellants' Designation of Portions of Record, Proceedings, and Evidence to Be Contained in Record on Appeal..... | 36 |

INDEX

PAGE

| | |
|--|----|
| Appellants' Statement of Points Relied Upon on Appeal | 32 |
| Appellants' Statement of Points Relied Upon on Appeal (CCA) | 81 |
| Certificate of Clerk to Transcript of Record on Appeal | 38 |
| Complaint | 2 |
| Findings of Fact and Conclusions of Law..... | 22 |
| Conclusions of Law..... | 27 |
| Findings of Fact..... | 22 |
| Judgment | 29 |
| Names and Addresses of Attorneys..... | 1 |
| Notice of Appeal..... | 31 |
| Opinion and Order..... | 16 |
| Plaintiffs' Proposed Amendments to Defendant's Proposed Findings of Fact..... | 18 |
| Stipulation, Application for Order, and Order Dispensing With Printing of Exhibit..... | 82 |
| Stipulation as to Issues of Fact..... | 12 |
| Stipulation and Order as to Transmission of Exhibits to United States Circuit Court of Appeals | 34 |
| Stipulation as to Reporter's Transcript on Appeal | 34 |

| INDEX | PAGE |
|---|------|
| Reporter's Transcript..... | 39 |
| Exhibits, Defendant's: | |
| B—Letter, 4/10/46: Merchants to Otis & Browne..... | 54 |
| C—Letter, 5/ 3/46: Merchants to Otis & Browne..... | 56 |
| Witnesses for Defendant: | |
| Browne, Edward Rambo | |
| —direct | 44 |
| Ritch, Fletcher Quinn | |
| —direct | 47 |
| —cross | 57 |
| —redirect | 61 |
| Witnesses for Plaintiff: | |
| Browne, Edward Rambo | |
| —direct | 63 |
| —cross | 68 |
| —redirect | 69 |
| —recross | 71 |
| Pagliero, Antone A. | |
| —direct | 71 |

NAMES AND ADDRESSES OF ATTORNEYS

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311 California Street,
San Francisco, California.

Attorneys for Defendant and Appellee.

In the Superior Court of the State of California,
in and for the County of Contra Costa

No. 38263

**ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, copartners
doing business under the fictitious firm name
and style of TECHNICAL PORCELAIN &
CHINAWARE COMPANY,**

Plaintiffs,

vs.

MERCHANTS FIRE ASSURANCE CORPORATION OF NEW YORK, a corporation,
Defendant.

COMPLAINT

The plaintiffs complain of the defendant, and for cause of action allege:

I.

That the defendant, Merchants Fire Assurance Corporation of New York, a corporation, at all times herein mentioned was, and now is, a corporation organized and existing under and by virtue of the laws of the State of New York, and was authorized and empowered to engage in the business of insurance of property against the risk of fire, amongst other perils, in the State of California.

II.

That the Technical Porcelain & Chinaware Company, Inc., a corporation (the original insured un-

der the policy hereinafter [1*] mentioned) was the owner of a parcel of real property situated in the City of El Cerrito, County of Contra Costa, State of California, improved with a building and which said property was being operated as a porcelain and chinaware manufacturing concern by said original insured, and that said building contained machinery and equipment, moulds, fire-fighting equipment, stores and supplies, stock, raw materials and other types of personal property at the time of its insurance and destruction by fire, as herein-after mentioned.

III.

That on the 26th day of June, 1944, in consideration of the payment by Technical Porcelain & Chinaware Company, Inc., a corporation, to the defendant of the premium of \$427.50, said defendant made its policy of insurance in writing, wherein and whereby said defendant agreed to insure the Technical Porcelain & Chinaware Company, Inc., against the risk of loss by fire in the amount of \$15,000.00 on all property of every kind and description, both real and personal, including buildings, together with all of their contents of whatever nature appurtenant to the business of the assured, (excluding, however, motor vehicles, accounts, bills, currency, evidences of debt or ownership of other documents, money, notes or securities) including all property on which by the printed conditions of said policy, it is required that liability

* Page numbering appearing at foot of page of original certified Transcript of Record.

be specifically assumed, owned by said insured or held by it in trust or on commission, or sold, but not removed, for which said assured may be responsible, and all while contained in and/or on the premises owned and operated by said insured, and while in and/or on sidewalks, yards and open spaces, provided such property be located within 50 feet of said premises and while in and/or on cars and/or vehicles within 300 ft. of the premises situated on the east side of Kearney Street, between Schmidt and Manila Avenues, and on the premises across the street on the north side of Manila [2] between Kearney and Liberty Streets, in El Cerrito, California.

IV.

That on or about the 15th day of December, 1944, with the consent of the defendant in writing endorsed on said policy, the said Technical Porcelain & Chinaware Co., Inc., a corporation, sold, assigned and conveyed to the plaintiff its interest in the property hereinbefore referred to and in said policy of insurance.

V.

That on or prior to the 15th day of December, 1944, Antone A. Pagliero and John B. Pagliero and Arthur J. Pagliero had formed a copartnership for the purpose of taking over the assets of the Technical Poreclain & Chinaware Company, Inc., and ever since December 15, 1944, Antone A. Pagliero and John B. Pagliero and Arthur J. Pagliero have been conducting said porcelain and chinaware manufacturing concern under the fic-

titious firm name and style of Technical Porcelain & Chinaware Company, and that plaintiffs have heretofore filed with the County Clerk of the County of Contra Costa, State of California, their business certificate showing the ownership of such business after due publication thereof once a week for four successive weeks in a newspaper published in said county in the manner required by Sections 2466 and 2468 of the Civil Code of the State of California.

VI.

That on or about the 22nd day of May 1946, the said property herein referred to was partially destroyed by fire. That plaintiff was damaged thereby in the amount of \$464,051.31; that at the time of said fire there was in full force and effect various policies of fire insurance with various fire insurance companies, including the defendant, in the total sum of \$315,000.00; that by reason of the 90 per cent. co-insurance clause contained in all of said policies, including the policy of the defendant, plaintiff became entitled to the sum of \$12,974.35 from the defendant. [3]

VII.

That after said fire and prior to July 21, 1946, the defendant denied liability on said policy of insurance, and thereby waived the benefits of the terms of said written policy of insurance requiring that proof of loss be made within sixty (60) days after the commencement of the fire, and said plaintiffs have otherwise duly performed all conditions of said policy on its part.

VIII.

That said defendant has not paid the said loss, nor any part thereof, and said amount of \$12,974.35 is now due and owing from defendant to plaintiff.

IX.

That the said contract of insurance hereinabove referred to in paragraph III, was made and entered into, and was and is to be performed in the County of Contra Costa, State of California; that the obligation of said defendant, and its liability arising out of said contract of insurance, arose in said County of Contra Costa, State of California.

X.

The Mechanic's Bank of Richmond, is named in said written policy of insurance under the "Lender's Loss Payable Endorsement" as a payee; that on October 18, 1946, said Mechanic's Bank of Richmond executed and delivered to plaintiff a written assignment of all rights of said lender payee under said policy.

Wherefore, plaintiffs pray judgment against defendant in the sum of \$12,974.35, with interest from the date of said fire, costs incurred herein, and for such other and further relief as to the Court may seem meet and proper in the premises.

HAUERKEN, AMES &
ST. CLAIR,
Attorneys for Plaintiffs.

State of California,
County of Contra Costa—ss.

Antone A. Pagliero, being first duly sworn, deposes and says:

That he is one of the partners of the firm of Technical Porcelain & Chinaware Company, the plaintiff in the above-entitled action; that he has read the foregoing complaint and knows the contents thereof, and the same is true of his own knowledge, except as to those matters therein stated to be alleged on information and belief, and as to those matters he believes it to be true.

/s/ ANTONE A. PAGLIERO.

Subscribed and sworn to before me this 18th day of October, 1946.

[Seal] LILLIAN W. CHASE,
Notary Public in and for the County of Contra Costa, State of California.

(Here follow certified copies of Petition for Removal of Cause to the United States District Court, in and for the Northern District of California, Southern Division; Memorandum of Points and Authorities in Support of Petition for Removal to the United States District Court; Bond on Removal; Notice of Petition for Removal and Order for Removal of Cause to the United States District Court, in and for the Northern District of California, Southern Division, and Certificate to above copies.)

[Endorsed]: Filed Dec. 20, 1946, C. W. Calbreath, Clerk.

In the United States District Court, in and for the
Southern Division of the Northern District of
California

No. 26704S

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, copartners
doing business under the fictitious firm name
and style of TECHNICAL PORCELAIN &
CHINaware COMPANY,

Plaintiffs,

vs.

MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK, a corporation,

Defendant.

ANSWER TO COMPLAINT

Comes now the defendant Merchants Fire Assurance Corporation of New York and answering the complaint on file admits, denies and alleges as follows:

I.

Defendant admits the allegations of Paragraphs I, III and IX of said complaint.

II.

Answering Paragraphs II, IV, V and X, defendant alleges that it has not sufficient information or belief to answer said allegations more particularly, and therefore and upon that ground it denies

the said allegations, save and except it admits said bank was named as a loss payee in said policy and that there is an endorsement indicating an assignment of interest.

III.

Answering Paragraph VI, defendant denies the allegations thereof, save and except it is admitted a fire occurred at said [6] premises on May 22, 1946, causing damage in the amount of \$464,051.31, that there was \$300,000 insurance in effect at said time and that each policy of insurance contained a 90% Average clause.

IV.

Answering Paragraph VII, defendant denies the said allegations. In this respect defendant alleges that in July, 1946, it informed plaintiffs that it appeared plaintiffs had taken out other insurance in substitution of defendant's policy and that defendant reserved whatever rights and defenses it had or such as might thereafter accrue to it; that thereafter and on July 23, 1946, plaintiffs filed a pur-
proof of loss with defendant and defendant immediately advised plaintiffs that same was defective and too late.

V.

Answering Paragraph VIII, defendant denies that the said sum of \$12,974.35, or any other sum is due and owing from it. Admits that it has not paid any part of said loss.

And as and for a separate and distinct and first affirmative defense, defendant alleges:

I.

That on or about April 10, 1946, plaintiffs through Otis & Browne, Inc., their brokers and duly authorized agents, obtained a policy of insurance in the Home Fire and Marine Insurance Company in the amount of \$15,000.00 in substitution for and in lieu of defendant's said policy; that thereupon defendant's policy was cancelled and terminated; that defendant is informed and believes that plaintiffs made claim and received payment under the policy of Home Fire and Marine Insurance Company for said loss.

And as and for a separate and distinct and second affirmative defense, defendant alleges:

I.

That in and by the defendant's policy of insurance it was and is provided as follows:

“Within sixty days after the commencement of the fire the insured shall render to the company at its main office in California named herein preliminary proof of loss consisting of a written statement signed and [7] sworn to by him setting forth: (a) his knowledge and belief as to the origin of the fire; (b) the interest of the insured and of all others in the property; (c) the cash value of the different articles or properties and the amount of loss

thereon; (d) all incumberances thereon; (e) all other insurance, whether valid or not, covering any of said articles or properties; (f) a copy of the descriptions and schedules in all other policies unless similar to this policy, and in that event, a statement as to the amounts for which the different articles or properties are insured in each of the other policies; (g) any changes of title, use, occupation, location or possession of said property since the issuance of this policy; (h) by whom and for what purpose any building herein described, and the several parts thereof, were occupied at the time of the fire.

* * * * *

Time for Commencement of Action. No suit or action on this policy for the recovery of any claim shall be sustained, until after full compliance by the insured with all of the foregoing requirements, nor unless begun within fifteen month. . . .”

II.

That the loss to plaintiff's property occurred on May 22, 1946; that plaintiffs failed to present proofs of loss to defendant within sixty days thereof, as in said policy provided; that plaintiffs presented a purported proof of loss to defendant on July 23, 1946, and were promptly advised by defendant that same was defective and delinquent;

Wherefore, defendant having fully answered, prays that it have judgment, that it recover its

costs and have such other and different relief as may be proper.

/s/ E. M. TAYLOR,

/s/ H. A. THORNTON,

THORNTON & TAYLOR,

Attorneys for Defendant,

Merchants Fire

Assurance Company.

Receipt of a copy of the foregoing Answer is acknowledged this 23rd day of December, 1946.

HAUERKEN, AMES &

ST. CLAIR,

Attorneys for Plaintiffs.

[Endorsed]: Filed Dec. 23, 1946.

[Title of District Court and Cause.]

**STIPULATION
AS TO ISSUES OF FACT**

It is hereby stipulated by and between the parties hereto, through their respective counsel, that each and every and all of the allegations contained in paragraphs I, II, III, IV, V, IX and X of plaintiff's complaint on file herein are true and correct, and it is further stipulated that no evidence to support said allegations need be offered at the trial of said cause.

With respect to paragraphs VI, VII and VIII of plaintiffs' complaint on file herein, it is hereby stipulated as follows:

(a) (With respect to paragraph VI) That on or about the 22d day of May, 1946, the said property herein referred to was partially destroyed by fire. That plaintiffs were damaged thereby in the amount of Four Hundred Sixty-four Thousand and Fifty-one and 31/100 (\$464,051.31) Dollars; that at the time of said fire there were in full force and effect various policies of fire insurance, with various fire insurance companies, excluding the defendant, in the total sum of Three Hundred Thousand (\$300,000) Dollars; that plaintiffs contend and defendant denies that at the time of said fire there was in full force and effect (and in addition to the insurance in the amount of Three Hundred Thousand (\$300,000) Dollars), a policy of the defendant to the plaintiffs in the amount of Fifteen Thousand (\$15,000) Dollars. That by reason of the 90% co-insurance clause contained in all said policies, including the policy of the defendant, if the Court should hold said policy of defendant in effect, plaintiffs, if entitled to judgment against defendant, would be entitled to judgment in the amount of Twelve Thousand Nine Hundred Seventy-four and 35/100 (\$12,974.35) Dollars.

(b) (With respect to paragraph VII) That after said fire and prior to July 21st, 1946, the defendant denied liability on said policy of insurance. [9]

(c) (With respect to paragraph VIII) That the defendant had not paid the said loss, nor any part thereof, to plaintiffs.

It is further stipulated by and between the parties hereto as follows:

1. That on July 23, 1946, plaintiffs presented to and filed with defendant a verified proof of loss under its policy #8604.
2. That on or about July 25, 1946, defendant informed plaintiffs in writing that said proof of loss was defective and that it had not been presented to defendant within the time required by said policy.
3. That at all times from February 6, 1945, to July 23, 1946, and thereafter, Otis & Browne, Inc., were acting as insurance brokers for plaintiffs.
4. That on April 10, 1946, Otis & Browne, Inc. received a request in writing from defendant to cancel and return defendant's said policy.
5. That upon receipt of said Notice, Otis & Browne, Inc., thereupon obtained a policy of fire insurance from the Home Fire & Marine Insurance Co. in the amount of \$15,000 insuring plaintiffs on its said property for the term from April 10, 1946, to 1949.
6. That thereafter and on May 3, 1946, defendant in writing again requested Otis & Browne, Inc., to return its said policy.
7. That in reply thereto, Otis & Browne, Inc., informed defendant in writing on May 7, 1946: "You may close your file as this has been replaced as of April 10-1946. Policy is at Mechanics Bank, Richmond and will require some time to secure unless you wish to send cancellation notice dated 10 days prior to April 10-1946."
8. That following the fire of May 22, 1946, plain-

tiffs made claim for and collected under said policy of the Home Fire & Marine Insurance Co., the sum of \$12,974.35. [10]

That the sole issues involved in the pending action are as follows:

1. The extent of the authority of Otis & Browne, Inc., as insurance brokers for plaintiff.
2. The legal effect of the acts and conduct of Otis & Browne, Inc., in obtaining a policy of insurance in a similar amount on the same property with the Home Fire & Marine Insurance Co., after their receipt of defendant's request for cancellation of its policy.
3. The legal effect of plaintiffs' having made claim for and having collected the full amount due under the said policy of the Home Fire & Marine Insurance Co.

The foregoing stipulation shall, however, be subject to all pertinent legal objections to admissibility of any of the above matters, which may be interposed at the trial by either party.

Dated: April 17th, 1947.

/s/ GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,

Attorneys for Plaintiffs.

/s/ H. A. THORNTON,

/s/ EVANS M. TAYLOR,

THORNTON & TAYLOR,

Attorneys for Defendant

Insurance Company.

[Endorsed]: Filed April 18, 1947 [11]

In the United States District Court in and for the
Southern Division of the Northern District of
California

No. 26704 L

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, Copartners,
doing business under the fictitious firm name
and style of TECHNICAL PORCELAIN &
CHINaware COMPANY,

Plaintiffs,

vs.

MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK, a corporation,
Defendant.

OPINION AND ORDER

The pressure of a heavy calendar prevents my writing an extended opinion in this case. There is due counsel, however, a brief statement of my conclusions.

Although there is evidence in the case which I believe will sustain a finding that Otis & Browne were general agents for the plaintiffs and as such were empowered to agree to cancellation of a policy or to effect a substitution of one policy for another, it seems to me that this case can be readily disposed of upon another ground. I believe that the facts impel a conclusion that there was a substitution of policies. Whether the agents had or did not

have authority to substitute at the time of the substitution, it very clearly appears to me that there has been ratification of the act of the agents.

Admittedly plaintiffs were informed of the substitution after the fire and prior to their making a [12] claim against the Home Fire Insurance Co. It was clearly the intent and purpose of Otis & Browne at the time they obtained the policy of the Home Fire Insurance Co. to substitute that in place of the policy here in question. With knowledge of that fact communicated to them by Otis & Browne they made claim against the Home Fire Insurance Co. and accepted payment from that company. This, to my notion, was a clear ratification of the act of substitution. The case of *Finley v. New Brunswick Fire Insurance Co.*, 193 Fed. 195, appears to me to be directly in point and the attempts made by counsel to differentiate that cases are not persuasive because the differentiations would have no effect upon the result reached. I am also very strongly persuaded by the law of the forum found in *Strauss v. Dubuque Fire & Marine Insurance Co.*, 132 Cal. App. 283.

Judgment will be for the defendant, findings to be prepared in accordance with the local rule.

Dated: October 16th, 1947.

DAL M. LEMMON,
United States District Judge.

[Endorsed]: Filed October 16, 1947. [13]

[Title of District Court and Cause.]

PLAINTIFFS' PROPOSED AMENDMENTS
TO DEFENDANT'S PROPOSED
FINDING OF FACT

Amendment No. 1.

That it is true that the Technical Porcelain & Chinaware Company, Inc., a corporation, was the original insured under the policy referred to in the complaint and was the owner of the property described therein; that on the 26th day of June, 1944, in consideration of the payment by said corporation to defendant of a premium of \$427.50 defendant issued to said corporation its policy of fire insurance in the amount of \$15,000 for the term from June 26th, 1944, to June 26th, 1947, as more particularly described in the complaint; that on or about the 15th day of December, 1944, with the consent of the defendant in writing [14] endorsed on said policy, said corporation sold, assigned and conveyed to plaintiffs its interest in the property referred to in said complaint and its interest in said policy of insurance.

Amendment No. 2.

That it is true that on or about the 22d day of May, 1946, the said property described in the complaint was partially destroyed by fire; that the said property had an actual cash value at the time of the fire in the amount of \$596,113.77; that as the result of said fire, plaintiffs were damaged in the amount of \$464,051.31; that at the time of said fire

there were in full force and effect various policies of insurance with various fire insurance companies, excluding defendant, in the total sum of \$300,000; that in each of said policies, as well as in the policy of defendant, there was and is a provision reading as follows:

“It is expressly stipulated and made a condition of the contract that, in event of loss, this company shall be liable for no greater proportion thereof than the amount hereby insured bears to ninety per cent (90%) of the actual value of the property described herein at the time such loss shall happen, nor for more than the proportion which this policy bears to the total insurance thereon.”

Amendment No. 3.

That it is true that after said fire and prior to July 21st, 1946, defendant denied liability on said policy of insurance and waived the necessity of the filing of a proof of loss by plaintiffs with defendant; that plaintiffs have duly performed all conditions of said policy on their part to be performed; that said defendant has not paid the sum of \$12,-974.35 claimed by plaintiffs from defendant.

Amendment No. 4.

That it is true that on or about May 3d, 1946, defendant wrote to Otis & Browne, Inc., as follows:

“We are following up a letter written to you on April 10 asking for cancellation of this policy. [15]

"We understood that you were going to relieve us of liability as soon as possible although no definite date was set for the termination.

"Will you kindly follow this up and endeavor to have our policy returned within the next ten days?"

That in reply thereto, Otis & Browne, Inc., wrote to defendant as follows:

"You may close your file as this has been replaced as of April 10 - 1946. Policy is at Mechanics' Bank Richmond and will require some time to secure unless you wish to send cancellation notice dated 10 days prior to April 10 - 1946."

Amendment No. 5.

That it is true that Otis & Browne, Inc., did not inform plaintiffs of defendant's request until about a week or ten days after said fire, whereupon plaintiffs stated to Otis & Browne, Inc., that plaintiffs accordingly were covered by insurance in the amount of \$315,000 instead of \$300,000.

Amendment No. 6.

That is is not true that the acts of Otis & Browne, Inc., in purporting to secure another policy in place of that of defendant, were performed within the scope and authority of their employment as plaintiffs' insurance brokers.

Amendment No. 7.

That it is true that Otis & Browne, Inc., had neither general authority, nor authority of any kind, to accept notice of cancellation or termination of the policy of defendant, nor of any other policy of insurance; that in their reply to defendant's letter of May 3d, 1946, suggesting to defendant that:

".. you (defendant) wish to send cancellation notice . ."

Otis & Browne, Inc., specifically informed defendant that they had no such authority.

Respectfully submitted,

HAUERKEN, AMES &

ST. CLAIR,

Attorneys for Plaintiffs.

Receipt of a copy of the within Plaintiffs' Proposed Amendments to Defendant's Proposed Findings of Fact is admitted this 29th day of October, 1947.

THORNTON & TAYLOR,

Attorneys for Defendant.

[Endorsed]: Filed October 29, 1947. [16]

[Title of District Court and Cause.]

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above entitled cause came on regularly for trial on Wednesday, September 17th, 1947, on the issues raised by the Complaint, the Answer thereto of defendant, as presented by the Requests for Admissions, the Answers thereto and particularly by the Stipulation as to Issues of Fact on file herein, Hauerken, Ames & St. Clair by George H. Hauerken appearing for plaintiffs, and Thornton & Taylor by Evans M. Taylor appearing for defendant, and evidence, oral and documentary, having been introduced, and after argument on briefs the cause having been submitted to the Court for decision, a jury having been waived, and the Court having considered the evidence and the law, and being fully advised, now makes and files its findings of fact and conclusions of law as follows: [17]

Findings of Fact

I.

That it is true that all times mentioned in the complaint the defendant was and is a foreign corporation transacting the business of insurance in the State of California;

II.

That it is true that at the times mentioned in the complaint Technical Porcelain & Chinaware Co., Inc., a corporation, owned the property therein

described; that on or about June 26, 1944, for the premium therein mentioned, defendant issued to said company its said policy of fire insurance thereon in the amount of \$15,000.00 for the term from June 26, 1944, to June 26, 1947, and that on or about December 15, 1944, said Technical Porcelain & Chinaware Co., a corporation, transferred said property and said policy to plaintiffs and that an endorsement to that effect was attached to said policy of insurance;

III.

That it is true that the Technical Porcelain & Chinaware Company, Inc., a corporation, was the original insured under the policy referred to in the complaint and was the owner of the property described therein; that on the 26th day of June, 1944, in consideration of the payment by said corporation to defendant of a premium of \$427.50 defendant issued to said corporation its policy of fire insurance in the amount of \$15,000 for the term from June 26th, 1944, to June 26th, 1947, as more particularly described in the complaint; that on or about the 15th day of December, 1944, with the consent of the defendant in writing endorsed on said property, said corporation sold, assigned and conveyed to plaintiffs its interest in the [18] property referred to in said complaint and its interest in said policy of insurance;

IV.

That it is true that ever since said time and up to the time of the fire hereinafter referred to,

plaintiffs were doing business as a co-partnership under the fictitious name of Technical Porcelain & Chinaware Co. and had filed the certificates of ownership required by sections 2466 and 2468 of the Civil Code of California;

V.

That it is true that on or about the 22nd day of May, 1946, the said property described in the complaint was partially destroyed by fire; that the said property had an actual cash value at the time of the fire in the amount of \$596,113.77; that as the result of said fire, plaintiffs were damaged in the amount of \$464,051.31; that at the time of said fire there were in full force and effect various policies of insurance with various fire insurance companies, excluding defendant, in the total sum of \$300,000; that in each of said policies, as well as in the policy of defendant, there was and is a provision reading as follows:

“It is expressly stipulated and made a condition of the contract that, in event of loss, this company shall be liable for no greater proportion thereof than the amount hereby insured bears to ninety per cent (90%) of the actual value of the property described herein at the time such loss shall happen, nor for more than the proportion which this policy bears to the total insurance thereon.”

IV.

That it is true that in and by defendant's said

policy The Mechanics Band of Richmond is named under a Lenders Loss Payable Endorsement; that it is true that said [19] bank transferred its rights, if any, thereunder to plaintiffs;

VII.

That it is true that at all times from February 6, 1945, to July 23, 1946, and thereafter Otis & Browne, Inc., were acting as insurance brokers for the plaintiffs, and during all said times handled plaintiffs' entire insurance portfolio; that it is true that defendant had been informed prior to said fire that Otis & Browne were plaintiffs' insurance brokers;

VIII.

That it is true that on or about April 10, 1946, defendant wrote to Otis & Browne, Inc., as follows:

“Will you kindly cancel this policy and return it to us for pro rata cancellation? The company has requested us to retire from the liability because we are no longer willing to accept this classification. If you prefer, we can send cancellation notice direct to the assured. However, we will not do so unless you specifically instruct us.”

IX.

That it is true that Otis & Browne received said letter and thereupon obtained a policy of fire insurance with the Home Fire & Marine Insurance Company in the amount of \$15,000.00 on plaintiffs'

said property, effective from April 10, 1946, to [20] April 10, 1949, and which policy was obtained for the purpose of replacing defendant's policy;

X.

That it is true that thereafter and on or about May 3, 1946, defendant again wrote to Otis & Browne about being relieved of liability; that it is true that Otis & Browne in reply and on or about May 7, 1946, informed defendant that its said policy had been replaced on April 10, 1946, and that the defendant could close its file;

XI.

That it is true that after the fire of May 22, 1946, Otis & Browne informed plaintiffs that they had obtained a policy for a similar amount with the Home Fire & Marine Insurance Company, to replace defendant's policy; that it is true that thereupon plaintiffs made claim for and collected the full amount due under the said policy of the Home Fire & Marine Insurance Company, and also made claim against this defendant for a like amount, and as to which defendant denied liability;

XII.

That it is true that the acts of Otis & Browne, Inc., in substituting another policy for that of defendant were performed within the scope and authority of their employment as plaintiffs' insurance brokers;

XIII.

That it is true that defendant waived the necessity for plaintiffs' filing a proof of loss. And that the defendant has denied liability on said policy and has not paid the sum of \$12,974.35 claimed by plaintiffs from defendant;

XIV.

That all of the allegations of plaintiffs' Complaint inconsistent with the foregoing findings are untrue.

Conclusions of Law

And as conclusions of law from the foregoing facts, the Court finds:

I.

That prior to the fire the defendant's policy of insurance [21] was replaced by another one, obtained as a substitution therefor;

II.

That following the fire plaintiffs, upon being informed as to the facts, ratified the acts of their brokers and the replacement and substitution of defendant's policy of insurance by one in another insurance company;

III.

That at the time of the fire liability under defendant's policy of insurance had been terminated by said policy having been replaced by one with another insurance company;

IV.

That plaintiffs are not entitled to recover from defendant under its said policy of insurance except they are entitled to the sum of \$190.25 as and for the unearned return premium, plus interest thereon at 7% per annum from April 10, 1946, to September 17, 1947, in the amount of \$19.11 as heretofore tendered them by defendant.

V.

That the defendant Merchants Fire Assurance Corporation, a corporation, is entitled to judgment and for its costs of suit.

Judgment is hereby ordered to be entered accordingly.

Dated: November 5th, 1947.

DAL M. LEMMON,
United States District Judge.

[Endorsed]: Filed Nov. 5, 1947. [22]

In the United States District Court in and for the
Southern Division of the Northern District of
California

No. 26704-L

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, Copartners;
Doing Business Under the Fictitious Firm
Name and Style of TECHNICAL PORCE-
LAIN & CHINAWARE COMPANY,

Plaintiffs,

vs.

MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK, a Corporation,
Defendant.

JUDGMENT

The above-entitled cause having come on regularly for trial on Wednesday, September 17, 1947, before the above-entitled Court, sitting without a jury, a jury having been waived, the action was then heard on the complaint, the answer thereto of defendant, and the Stipulation as to Issues of Fact, Hauerken, Ames & St. Clair by George H. Hauerken appearing for plaintiff, and Thornton & Taylor by Evans M. Taylor, appearing for the defendant, and evidence, both oral and documentary, having been introduced and the parties having rested, and the cause having been fully argued on briefs and being thereupon submitted for decision, and the Court having heretofore made and caused to be filed herein its written findings of facts and conclusions of law, and being fully advised: [23]

Wherefore, by reason of the law and the findings of fact aforesaid, it is ordered, adjudged and decreed :

- (1) That the plaintiffs take nothing by reason of said complaint, other than that adjudged in paragraph 3 following.
- (2) That the defendant do have and recover of and from plaintiffs their costs of suit herein in the amount of \$
- (3) That plaintiffs do have and recover of defendant the sum of \$190.25 as and for the unearned return premium, plus interest thereon at 7% per annum from April 10, 1946, to September 17, 1947, in the amount of \$19.11 as heretofore tendered them by defendant.

Dated: November 5th, 1947.

DAL M. LEMMON,
Judge of the United States
District Court.

[Endorsed]: Filed and Entered Vol. V.—Pg.
283, November 5, 1947. [24]

[Title of District Court and Cause.]

NOTICE OF APPEAL TO THE UNITED
STATES CIRCUIT COURT OF APPEALS
FOR THE NINTH CIRCUIT

Notice is hereby given that Antone A. Pagliero, John B. Pagliero and Arthur J. Pagliero, copartners, doing business under the fictitious firm name and style of Technical Porcelain & Chinaware Company, plaintiffs above named, hereby appeal to the United States Circuit Court of Appeals for the Ninth Circuit from the final judgment entered in the above-entitled action in favor of defendant and against plaintiffs on the 5th day of November, 1947, and from each and every part thereof.

/s/ GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,
Attorneys for Plaintiffs.

(Acknowledgment of Receipt of Copy.)

[Endorsed]: Filed Dec. 4, 1947. [25]

[Title of District Court and Cause.]

APPELLANTS' STATEMENT OF POINTS RELIED UPON ON APPEAL

In accordance with the provisions of Rule 75(d) of the Federal Rules of Civil Procedure, appellants hereby state the points upon which they intend to rely on appeal:

- (1) The court erred in finding and holding that the acts of Otis & Browne, Inc., "in substituting another policy for that of defendant," were performed within the scope and authority of their employment as plaintiffs' insurance brokers, for the following reasons:
 - (a) There is no evidence in the record tending to show that Otis & Browne, Inc., were specifically authorized to do said acts. [26]
 - (b) There is no evidence in the record tending to show that Otis & Browne, Inc., were generally authorized to do said acts.
 - (c) There is no evidence in the record tending to show that Otis & Browne, Inc., were general insurance agents for plaintiffs. On the contrary, the only evidence in the record shows that Otis & Browne, Inc., were only insurance brokers for plaintiffs. As such, and without prior additional authority, they were not authorized to do said acts.

(2) The court accordingly erred in admitting in evidence defendant's Exhibits B and C, as these exhibits were not shown to have been sent by defendant to an agent of plaintiffs authorized to receive and act upon them.

(3) The court erred in finding and holding that plaintiffs "ratified the acts of their brokers and the replacement and substitution of defendant's policy of insurance by one in another insurance company."

(4) The court erred in finding and holding that defendant's policy of insurance was replaced by another policy, obtained as a substitution therefor, for the reason that there is no so-called doctrine of substitution in the law of insurance, that name being used only to describe a variety of situations, none of which is like that presented in this case.

(5) Assuming a so-called doctrine of substitution to exist in the law of insurance, the court erred in applying that doctrine to the facts of the present case, for the reason that it is not applicable to those facts.

/s/ GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,
Attorneys for Plaintiffs and
Appellants.

(Acknowledgment of Receipt of Copy.)

[Endorsed]: Filed Dec. 15, 1947. [27]

[Title of District Court and Cause.]

STIPULATION AS TO REPORTER'S
TRANSCRIPT ON APPEAL

It is hereby stipulated by and between the parties hereto, through their respective counsel, and pursuant to Rule 21 of the rules of the above-entitled Court, that one copy only of the Reporter's transcript of the above-entitled action need be filed with the above-entitled Court for the purpose of the preparation of the record on appeal.

Dated: December 12, 1947.

/s/ GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,
Attorneys for Plaintiffs and
Appellants.
E. M. TAYLOR,
THORNTON & TAYLOR,
Attorneys for Defendant and
Appellee.

[Endorsed]: Filed December 15, 1947. [28]

[Title of District Court and Cause.]

STIPULATION AND ORDER AS TO TRANSMISSION OF EXHIBITS TO UNITED STATES CIRCUIT COURT OF APPEALS

It is hereby stipulated by and between the parties hereto, through their respective counsel, and

pursuant to Rule 75(i) of the Federal Rules of Civil Procedure, that the following exhibits on file herein, to wit plaintiffs' Exhibits No. 1 and No. 2 and defendant's Exhibits B and C, need not be copied into the record on appeal, but that the original of said exhibits may be transmitted to the United States Circuit Court of Appeals for the Ninth Circuit, to be inspected by said Circuit Court of Appeals, and that said original exhibits may be deemed a part of the record on appeal in the above-entitled action.

Dated: San Francisco, California, this 12th day of December, 1947.

/s/ **GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,**
Attorneys for Plaintiffs and
Appellants.

**EVANS M. TAYLOR,
THORNTON & TAYLOR,**
Attorneys for Defendant and
Appellee.

It is so ordered.

Dated: San Francisco, California, this 15th day of December, 1947.

DAL M. LEMMON,
United States District Judge.

[Endorsed]: Filed December 15, 1947. [30]

[Title of District Court and Cause.]

APPELLANTS' DESIGNATION OF PORTIONS OF RECORD, PROCEEDINGS, AND EVIDENCE TO BE CONTAINED IN RECORD ON APPEAL.

In accordance with the provisions of Rule 75 of the Federal Rules of Civil Procedure, plaintiffs and appellants, Antone A. Pagliero, John B. Pagliero and Arthur J. Pagliero, copartners doing business under the fictitious firm name and style of Technical Porcelain & Chinaware Company, having appealed from the judgment entered against them and in favor of defendant and appellee, Merchants Fire Assurance Corporation of New York, a corporation, in the above-entitled action by the above-entitled court, to the United States Circuit Court of Appeals for the Ninth Circuit, hereby designate the following portions of the record, proceedings and evidence in said action [31] as the portions of such record, proceedings and evidence to be contained in the record on appeal:

- (1) Complaint.
- (2) Answer.
- (3) Stipulation As To Issues Of Fact.
- (4) Findings Of Fact And Conclusions Of Law.
- (5) Plaintiffs' Proposed Amendments To Defendant's Proposed Findings Of Fact.
- (6) Opinion And Order.
- (7) Judgment.
- (8) Notice Of Appeal.
- (9) Appellants' Statement Of Points Relied Upon On Appeal.

- (10) The copy of the entire Reporter's transcript of the evidence and proceedings at the trial, certified by the official Reporter of the above-entitled court, who stenographically reported and transcribed such evidence and proceedings, and heretofore filed with the Clerk of the above-entitled court.
- (11) Stipulation As To Reporter's Transcript On Appeal.
- (12) The following original exhibits, to wit plaintiffs' Exhibits No. 1 and No. 2 and defendant's Exhibits B and C, in accordance with the Stipulation And Order As To Transmission Of Exhibits To United States Circuit Court Of Appeals on file herein.
- (13) Stipulation And Order As To Transmission Of Exhibits To United States Circuit Court Of Appeals.
- (14) This Designation Of Portions Of Record, Proceedings, And Evidence To Be Contained In Record On Appeal.

/s/ GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,
Attorneys for Plaintiffs and
Appellants.

Receipt of a copy of the foregoing designation is hereby admitted this 12th day of December, 1947.

THORNTON & TAYLOR,
Attorneys for Defendant and
Appellee.

[Endorsed]: Filed December 15, 1947. [32]

District Court of the United States
Northern District of CaliforniaCERTIFICATE OF CLERK TO TRANSCRIPT
OF RECORD ON APPEAL

I, C. W. Calbreath, Clerk of the District Court of the United States, for the Northern District of California, do hereby certify that the foregoing 32 pages, numbered from 1 to 32, inclusive, contain a full, true, and correct transcript of the records and proceedings in the case of Antone A. Pagliero, et als., Plaintiffs, vs. Merchants Fire Assurance Corporation of New York, a corporation, Defendant, No. 26704L, as the same now remain on file and of record in my office.

I further certify that the cost of preparing and certifying the foregoing transcript of record on appeal is the sum of \$6.50 and that the said amount has been paid to me by the Attorney for the appellant herein.

In witness whereof, I have hereunto set my hand and affixed the seal of said District Court at San Francisco, California, this 12th day of January A. D. 1948.

[Seal] /s/ C. W. CALBREATH,
Clerk.

In the United States District Court for the Southern
Division of the Northern District of California

No. 26704S

**ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, copartners
doing business under the fictitious firm name
and style of TECHNICAL PORCELAIN &
CHINAWARE COMPANY,**

Plaintiffs,

vs.

**MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK, a corporation,**
Defendant.

Before: Hon. Dal M. Lemmon, Judge.

REPORTER'S TRANSCRIPT

San Francisco, California,
Wednesday, September 17, 1947

Appearances:

For the Plaintiffs: George H. Hauerken, Esq.,
Russ Bldg., San Francisco 4, Calif.

For the Defendant: Evans M. Taylor, Esq., 311
California Street, San Francisco 4, Calif.

The Clerk: Pagliero vs. Merchants Fire Assur-
ance Corporation for trial.

Mr. Hauerken: That is ready.

Mr. Taylor: Ready.

The Court: I take it from the stipulation as to
facts that the scope of the evidence to be offered

in the trial of this case today is restricted and confined to the extent of the authority of the insurance brokers and the legal effect of the acts of the insurance brokers.

Mr. Hauerken: Yes.

Mr. Taylor: That is correct.

Mr. Hauerken: Yes, your Honor, the original stipulation, I assume, is on file.

Mr. Taylor: April 17, 1947.

Mr. Hauerken: That stipulation is on file. That is true, your Honor, that is, that the issues are confined to the legal effect of the conduct and the authority of the broker.

The Court: Before we took up any of the legal problems involved I wanted to confine the scope of the evidence to be received today if there were any limits that counsel were in a position to agree on. So with that understanding you may proceed to submit your evidence as to the scope of his authority. [2*]

Mr. Hauerken: I think at the outset, your Honor, so that the Court will have before it certain documentary evidence and a further stipulation that has been entered into, I would like to offer in evidence the original policy of the Merchants Fire Assurance Corporation, the defendant herein, as the plaintiffs' first in order.

(The document referred to was marked plaintiffs' Exhibit No. 1.)

Mr. Hauerken: Then inasmuch as the policy provides that loss, if any, is payable to the Me-

chanics Bank of Richmond and the policy holder, as their interests may appear, I now offer in evidence the original assignment to the Mechanics Bank of Richmond.

The Court: That has been stipulated to, has it not?

Mr. Taylor: It has, your Honor, but may I say this: while we agreed on the facts I did not want the record to show it had been stipulated without some proof being offered on that score.

The Court: Of course, the efficacy of the stipulation is to do away with the necessity of proof, but if you want it, let it go in.

(The document referred to was marked plaintiffs' Exhibit No. 2.)

Mr. Hauerken: Then there is just one other point—[3] not covered, inadvertently—and that is in paragraph 7 of the complaint there is an allegation that plaintiff has otherwise duly performed all conditions of said policy on its part.

Now counsel have agreed to stipulate that the plaintiffs have otherwise duly performed all conditions of the policy on its part with this exception: It is alleged—in the stipulation of facts there is a provision that after said—you will find this on page 2 of the stipulation, line 17—"that after said fire and prior to July 21, 1946, the defendant denied liability on said policy of insurance."

Now the effect of that—the fire happened on May 22, 1946, and there is a 60 day provision for filing proof of loss—the effect of that, and there

are a legion of California cases on the subject that if an insurance company denies liability the filing of a proof of loss is an idle act and need not be done. Mr. Taylor has stipulated they have denied liability within the 60 day period; accordingly we take the position that the filing of a proof of loss is something which is done just as a matter of courtesy or out of an abundance of caution.

Mr. Taylor, I suppose, has some point he may want to raise on that, and I wanted to explain that. At any event, there is that stipulation that the plaintiffs have performed all the conditions of said policy on their part except that [3] a proof of loss was filed on July 23.

The Court: I thought because of your stipulation you made no point of that.

Mr. Hauerken; I think he has abandoned that.

Mr. Taylor: Yes, that may be passed.

Mr. Hauerken: On that point, I take it, the plaintiff has no evidence to offer and we may go to the affirmative defense of the defendant on the matter of whether—Mr. Taylor subpoenaed Otis & Browne to be here—they were the insurance brokers. I talked to Mr. Browne yesterday and he assured me he would be here at ten, and I talked to him about nine o'clock this morning and he said he would be here at ten minutes to ten. I cannot understand why he is not here on time.

The Court: Did you definitely tell him what court to come to?

Mr. Hauerken: Yes, I told him Room 307 in the Post Office Bldg., Seventh and Mission.

Mr. Pagliero is here and I—Here is Mr. Browne right now.

Mr. Taylor: Mr. Browne, will you take the stand, please. [4]

EDWARD RAMBO BROWNE
called by the defendant, Sworn.

Mr. Hauerken: If your Honor please, I would like to say this just before we proceed: Your Honor will notice in the last paragraph of the stipulation that "The foregoing stipulation shall, however, be subject to all pertinent legal objections to the admissibility of any of the above-mentioned matters, which may be interposed at the trial by either of the parties, and I do want to interpose some legal objections as to the relevancy of some of the matters referred to, those affirmative matters that are contained therein on the part of the defendant, and I should like—let us say offer the stipulation subject to motions to strike at the conclusion of the evidence, so that your Honor may have all the evidence. For instance, I make this point: the policy of fire insurance contains a clause, and there is no dispute on this at all, that if the insurance company wants to cancel the policy it may do so by a five day written notice to the policy holder.

Now admittedly that was not done in this case.

There are California cases that hold that a course of conduct with an insurance broker with respect to matters of this nature are simply not in point if the—as a matter of fact, the policy must be strictly complied with or that is all there is to it. [5]

(Testimony of Edward Rambo Browne.)

The Court: There isn't any occasion for your objections. You have stipulated to facts here that you apparently have agreed upon, but the effect and sufficiency of those points are legal problems to be considered.

Mr. Hauerken: I would like to suggest that the stipulation be accepted subject to our right—probably your Honor will want us to file briefs at the conclusion of the trial—it is a very interesting and rather unique point of law; there are not many cases on the subject. May the stipulation be received subject to our right to object to the sufficiency—

The Court: I think you always have that right if the proof does not measure up to the facts.

Mr. Hauerken: The proof will measure up to the facts. It is just a question of the relevancy.

The Court: There is no question as to the facts being true; it is just a question of the legal sufficiency.

Mr. Hauerken: Yes. I just wanted to state my position on that.

Direct Examination

By Mr. Taylor:

Q. Mr. Browne, your name is Edward Rambo Browne? A. Yes.

Q. And you are president—

If your Honor please, I am calling this witness under Section 45 (b) of the Federal Rules of Procedure.

(Testimony of Edward Rambo Browne.)

And you are president of Otis & Browne, Incorporated? A. Yes.

Q. And your business is and for *some has* been been that of insurance brokers, is that right?

A. I am the third generation in this city.

Q. You were served with a subpoena duces tecum for the production of certain documents, were you not? A. Yes.

Q. Did you bring a document with you pursuant to the service of that subpoena dated on or about December 14, 1944, that had been addressed to you by the plaintiffs in this case with respect to your acting as an insurance broker?

A. I have no such document.

Q. You have no such document? A. No.

Q. Did you bring with you a document or letter dated on or about February 5, 6 or 7 addressed to you by the plaintiffs in this case with respect to your acting as an insurance broker?

A. No, I have no such document.

The Court: You mean by that that you haven't those documents here or they do not exist?

A. They do not exist, your Honor.

Q. (By Mr. Taylor): You are familiar—if I may just [7] shorten this—you are familiar with the documents requested in that subpoena. Did you bring any of the documents requested?

A. I brought the last mentioned documents in the subpoena there on the table by my hat, and they consist of insurance policies and a letter.

Q. But nothing with respect to any communica-

(Testimony of Edward Rambo Browne.)
tion from the plaintiffs individually or as a co-partnership under the name of Technical Porcelain & Chinaware Company, or from Technical Porcelain & Chinaware Company, a corporation, with respect to your acting as broker?

A. We never received any communication from them; just individually—

Mr. Taylor: Just a moment. I ask that the answer go out as not responsive.

The Court: It may go out.

Mr. Taylor: If your Honor—

Q. Answer the question directly. You didn't bring any such documents?

A. I didn't have them to bring.

Q. You made a search for them, did you?

A. I never received such a document.

Q. Will you answer the question?

May the answer go out?

Did you make a search for that record? [8]

A. I have gone through the records extremely carefully and there is no such document and I assure you there is no such document.

Mr. Taylor: I ask that the last part of the answer go out as not responsive.

The Court: "I assure you there is no such document" may go out.

Mr. Taylor: That is all from this witness right now, if your Honor please.

Mr. Hauerken: No questions.

Mr. Taylor: Mr. Ritch.

FLETCHER QUINN RITCH

called for the defendant, Sworn.

Direct Examination

By Mr. Taylor:

Q. Mr. Ritch, what is your business?

A. What?

Q. What is your business?

A. I am one of the underwriters at the Merchants Fire Assurance Company of New York.

Q. And how long have you been with the Merchants Fire Assurance Company, the defendant in this case?

A. It will be four years—five years next October.

Q. You were then with them in December of 1944? A. I was. [9]

Q. And have been continuously with them from that date to the present date? A. I have.

Q. Calling your attention to the time of on or about February 6, 1945, and with respect to the policy number 8604 which is the subject of this action, did you have any occasion to have any communication or contact with Otis & Browne with regard to that policy? A. I did, yes.

Q. When did that contact occur?

A. At the time of the fire, around about February 7, 1945, some one—Mr. Browne or some one in his office came in with a letter authorizing them to act as brokers.

Mr. Hauerken: Just a moment. I submit the answer is not responsive, your Honor.

(Testimony of Fletcher Quinn Ritch.)

The Court: Yes. It is beyond the scope of the question.

Q. (By Mr. Taylor): Let me ask you this, Mr. Ritch, on or about February 6 of 1945 you had contact with Otis & Browne with respect to this policy, did you? A. I did, yes.

Q. Did they present any document to you at that time with reference to the subject policy?

A. A letter signed by Mr. A. A. Pagliero, as near as I can recall. [10]

Q. Did you make any notation at that time with regard to such a letter?

A. I made a notation on that copy of our policy called the daily report.

Q. Have you got that with you?

A. I have.

Q. Will you let me see that, please?

A. (The witness produces document.)

Q. This document that you have handed me is the daily report or company record of this policy that the Merchants had issued to the plaintiffs in this case, is that right? A. Yes, sir.

Q. Number 8604, and the original policy having been introduced in evidence as Plaintiffs' Exhibit No. 1, will you examine that daily report—

The Court: Has counsel seen it?

Mr. Hauerken: I have not seen it, no. I would like to see this just a moment.

(The document was exhibited to Mr Hauerken.)

(Testimony of Fletcher Quinn Ritch.)

Q. (By Mr. Taylor): Will you examine that daily report, please——

And I will ask this be marked defendant's exhibit for identification.

(The document referred to was marked Defendant's Exhibit A for Identification.) [11]

Mr. Hauerken: That was offered for identification only?

Mr. Taylor: Yes, it was, Mr. Hauerken.

Q. I will ask you to examine what has been marked Defendant's Exhibit A for Identification, Mr. Ritch, and show me where on that document you made such a notation as to such a letter as you referred to from Otis & Browne.

A. A notation in pencil on the right-hand corner—not corner, but side of the daily report made at that time.

Q. What does your memorandum in that respect state?

A. "Letter signed by A. A. Pagliero to recognize Otis & Browne, Incorporated, as their brokers."

Q. And does that refresh your recollection as to that letter which was presented to you by Otis & Browne at that time?

A. The regular letter stating that they were to be their insurance brokers.

Q. At that time did Otis & Browne present to you anything else with respect to such policy?

A. Two endorsements.

(Testimony of Fletcher Quinn Ritch.)

Q. Two endorsements. Will you call attention, please, to the endorsements that you refer to as having been presented to you at that time by Otis & Browne?

A. One is what they call a policy form, a new amended form to be attached to the policy, mimeographed, with the [12] office stamp on the corner of Otis & Browne, Incorporated. Another was the attachment of an extended coverage endorsement.

Q. And that form which you have just related is a mimeographed form, is it not, of two pages?

A. Yes, sir.

Q. And I will call your attention to the fact that in the lower left-hand corner of the first page it has "Otis & Browne, Incorporated, Insurance, San Francisco, Los Angeles," is that so?

A. Yes.

Q. And the other document as to the extended coverage endorsement.

A. The other document as to the extended coverage endorsement.

Q. What did they present those endorsements to you at that time for?

A. To be signed and attached to the policy.

Q. And they were attached to such policy?

A. They were.

Mr. Taylor: If your Honor please, I will offer this daily report as defendant's exhibit next in order.

Mr. Hauerken: I will object to the introduction of it, your Honor, it is not evidence. It was

(Testimony of Fletcher Quinn Ritch.)

used merely to refresh this man's recollection of a note he made at the [13] time. It does not amplify his testimony. It is a self-serving document to that extent. He had made an outright statement that a letter was delivered to him. This was used, as I understand it, merely for the purpose of refreshing his recollection—

The Court: Well, I understood the papers were to be attached to the policy.

Mr. Hauerken: That is right, and the policy is in evidence with the attachments.

Mr. Taylor: The endorsements have been attached.

Mr. Hauerken: There is no question about Otis & Browne having presented—Otis & Browne are insurance brokers—

The Court: I am inclined to agree with you, that the memorandum was used for the purpose of refreshing the memory of this witness, and aside from that it would be self-serving. The objection is sustained.

Mr. Taylor: Now, if your Honor please, in furtherance of the stipulation that has been signed and to complete the record and to show the documents that were referred to in that stipulation, that is, the letters requesting termination of the liability by the Merchants that were addressed to Otis & Browne, it has been agreed that there is no necessity for the originals to be produced, and I would therefore like to—

Mr. Hauerken: I have the originals, so we might as well have them. [14]

(Testimony of Fletcher Quinn Ritch.)

Mr. Taylor: All right.

(Mr. Hauerken hands document to Mr. Taylor.)

Mr. Hauerken: Will you give me a copy of it if you have a copy?

Mr. Taylor: Yes; I have one here.

Now, if your Honor please, I would like to offer next in evidence a letter on the letterhead of Merchants Fire Assurance Corporation, pursuant to stipulation, dated April 10, 1946, that was addressed to Otis & Browne, Inc., 233 Sansome Street, San Francisco, California, which reads as follows:

"Will you kindly cancel this policy and return it to us for pro rata cancellation? The company has requested us to retire from the liability because we are no longer willing to accept this classification. If you would prefer, we can send cancellation notice direct to the assured. However, we will not do so unless you specifically instruct us."

Mr. Hauerken: We object to the relevancy of that document, your Honor. I refer your Honor to the case of Lauman vs. Concordia Fire Insurance Co., in which it was held substantially that a firm whose practice and custom, in relation to the cancellation of insurance policies, is to protect the assured in some other company, if possible, and to notify him of the cancellation of his policy by

(Testimony of Fletcher Quinn Ritch.)

either sending him a new policy or advising him that they cannot replace it, and requesting a return of the policy, are mere [15] brokers, and as such are without authority to accept notice of cancellation.

And the case goes on further to say that an agency to procure insurance is ended when the policy is procured and delivered to the principal, and the agent has no power after the policy is so delivered to consent to a cancellation, or to accept notice of an intended cancellation by the insurer; and that the evidence of usage to give notice to a broker is inadmissible where the policy requires notice to the insured.

There are a number of cases on that point. I just cited one to show the attempt to cancel through the medium of a broker is legally without effect.

The Court: The objection is overruled.

Mr. Taylor: We offer that letter of April 10th as defendant's exhibit next in order.

(The document referred to was marked Defendant's Exhibit No. B.)

(Testimony of Fletcher Quinn Ritch.)

DEFENDANT'S EXHIBIT B

[Letterhead] Merchants Fire Assurance Corporation of New York.

April 10, 1946.

Otis & Browne, Inc.
233 Sansome St.,
San Francisco, Calif.

Gentlemen:

Re: Policy #8604
Technical Porcelain Co.

Will you kindly cancel this policy and return it to us for pro rata cancellation?

The Company has requested us to retire from the liability because we are no longer willing to accept this classification. If you would prefer, we can send cancellation notice direct to the assured. However, we will not do so unless you specifically instruct us.

Yours very truly,
/s/ H. F. ROHRBACH,
Manager.

HFR:ES

[Notation]: Canc P R 4/10/46.

[Stamped]: Received Otis & Browne, Inc., Apr. 11, 1946.

[Endorsed]: Filed U.S.D.C. Sept. 17, 1947.

Mr. Taylor: Now, if your Honor please, pursuant to the stipulation of facts, we would next like to offer in evidence a letter on the letterhead of Merchants Fire Assurance Corporation of New

(Testimony of Fletcher Quinn Ritch.)

York, under date of May 3d, 1946, which is addressed to Otis & Browne, 233 Sansome Street, San Francisco, California, reading as follows:

“Re: Policy No. 8604, Technical Porcelain Company.

“We are following up a letter written to you on April [16] 10th asking for cancellation of this policy.

“We understood that you were going to relieve us of liability as soon as possible although no definite date was set for the termination.

“Will you kindly follow this up and endeavor to have our policy returned within the next ten days?

“Yours very truly,

“H. F. ROHRBACH,

“Manager.”

At the bottom of that letter in ink is the following notation, which pursuant to the stipulation of facts was made by Otis & Browne on this same letter returned to Merchants: “You may close your file as this has been replaced as of April 10, 1946. Policy is at Mechanics Bank, Richmond, and will require some time to secure unless you wish to send cancellation notice dated ten days prior to April 10, 1946.”

That letter, if your Honor please, bears a receipt stamp of Merchants Fire under date of May 7, its date being May 3, 1946.

(Testimony of Fletcher Quinn Ritch.)

Mr. Hauerken: There is no question as to the validity of the document, your Honor.

Mr. Taylor: I am just stating for the purpose of completing the record the marks appearing on the document. It also bears the receipt stamp of Otis & Browne, Incorporated, under date of May 4, 1946, indicating it was received by Otis & Browne the day after it was written and was returned [17] to Merchants by them on May 7th.

I offer that as defendant's exhibit next in order.

The Court: I presume you make the same objection?

Mr. Hauerken: The same objection as to the last document.

The Court: Overruled. Received.

(The document referred to was marked Defendant's Exhibit C.)

DEFENDANT'S EXHIBIT C

[Letterhead] Merchants Fire Assurance Corporation of New York.

May 3, 1946.

Otis & Browne, Inc.,
233 Sansome St.,
San Francisco, Calif.

Gentlemen:

Re: Policy #8604
Technical Porcelain Co.

We are following up a letter written to you on April 10 asking for cancellation of this policy.

We understood that you were going to relieve us

(Testimony of Fletcher Quinn Ritch.)
of liability as soon as possible although no definite date was set for the termination.

Will you kindly follow this up and endeavor to have our policy returned within the next ten days?

Yours very truly,

/s/ H. F. ROHRBACH,
Manager.

HFR:ES

[Stamped]: Received Otis & Browne, Inc., May 4, 1946. Received May 7, 1946. Pacific Dept. M.F.A.C.

[Notation]: You may close your file as this has been replaced as of April 10, 1946. Policy is at Mechanic's Bank, Richmond, and will require some time to secure unless you wish to send cancellation notice dated 10 days prior to April 10, 1946.

[Endorsed]: Filed U.S.D.C., Sept. 17, 1947.

Mr. Taylor: That is all as far as this witness is concerned.

Cross-Examination

By Mr. Hauerken:

Q. Mr. Fitch, will it help you any if I give you this policy, the original policy (handing document to witness)? I want to refer to some dates. I think possibly it may be of some help to you. What is the effective date of that policy of Merchants Fire Insurance? It is on the policy, Plaintiff's Exhibit No. 1. A. June 26, 1944.

Q. Who were the insurance brokers who originally procured that policy from you for the plaintiffs in this case?

(Testimony of Fletcher Quinn Ritch.)

A. It came to us through the general agent, Elmer H. Cords.

Q. Isn't it a fact that the policy was placed with your general agent by an insurance broker in Oakland known as Myer Lightner & Company?

A. Myer Lightner & Company. [18]

Q. So the insurance broker who procured this policy was Myer Lightner and not Otis & Browne?

A. They were the original brokers.

Q. Myer Lightner procured this policy from you for the plaintiffs?

A. No, the Cords agency wrote it over in Oakland.

Q. The Cords Agency was agent of the Merchants Fire Assurance, is that right? A. Yes.

Q. As your agents they accept business from insurance brokers, do they not? A. Yes.

Q. And in this particular case your agents, the Cords Company, received this business from Myer Lightner, insurance brokers, is that not a fact?

A. On the back of the policy there is an inter-office memorandum from Myer Lightner, otherwise I wouldn't know.

Q. But that being on the policy tells us that Myer Lightner were the brokers and Cords were the agents?

A. They were brokers up to the time—

Q. Just answer the question. I am asking at the time the policy was procured.

A. They were the brokers.

Q. Now attached to this policy is this mimeo-

(Testimony of Fletcher Quinn Ritch.)

graphed statement or form which Mr. Taylor referred to, dated February [19] 6, 1945. You saw that form, mimeographed form, did you not?

A. Yes, sir.

Q. That is the form that you referred to when you testified as to the mimeographed form bearing the name of Otis & Brown, Inc.?

A. That is the one.

Q. It is dated February 6, 1945?

A. Right.

Q. Who is the M. C. Brown who signed this for the defendant?

A. A clerk who was attaching the endorsements to the policy, a young lady who is no longer with me.

Q. As you say, on February 7, some one from Otis & Browne presented to you a letter of authorization signed A. A. Pagliero?

A. On or about that date, yes, sir.

Q. Who from Otis & Browne presented that letter to you?

A. As near as I can remember Mr. Browne came in with the letter and the endorsement.

Q. You say as near as you can remember. Do you have a definite recollection or are you just assuming that it must have been—

A. That is over two years ago. There are a hundred brokers—

Q. You can't be sure who presented it?

A. Somebody from his office. [20]

Q. Where is that letter, Mr. Ritch?

A. Mr. Browne took it with him promising to

(Testimony of Fletcher Quinn Ritch.)

mail a copy the next day. He only had one original.

Q. You say Mr. Browne took it with him and yet you are not entirely sure that Mr. Browne is the individual who came in with it, are you?

A. As sure as I can be.

Q. What did that letter say?

A. I don't remember the wording; just a form letter saying Otis & Browne, Incorporated—

Q. Now just a moment. Do you remember the wording or don't you remember the wording?

A. As I remember the exact wording it was just a statement naming a new broker, asking the company to recognize Otis & Browne as its insurance broker.

Q. That is all it said?

A. Well, a few extra words, but that is the common—

The Court: Just that general statement? There was nothing added as to what the authority was, was there?

A. The policy number and everything, asking the company to recognize Otis & Browne, Incorporated, as their insurance brokers.

Q. It had upon it your policy number?

A. Policy number—

Q. This particular policy number? [21]

A. I don't remember whether the policy number was on that letter or not, but—

Q. Well, if it wasn't this policy number what was it?

A. It was a form that came in with the letter and that had the policy number on.

(Testimony of Fletcher Quinn Ritch.)

Q. Was there more than one number?

A. Just one policy number on each endorsement.

Q. (By Mr. Hauerken): Well, this letter that you referred to, was it attached to this endorsement? Was it a letter saying, "Attached find endorsement which we want you to attach to our policy?"

A. No, the letter was, just as I said, asking us to recognize Otis & Browne as their insurance brokers.

Q. And that is all? A. To that effect.

Mr. Hauerken: You are sure of that. That is all.

Redirect Examination

By Mr. Taylor:

Q. Mr. Fitch, do you remember whether in that letter that was exhibited to you at the time these endorsements were exhibited and delivered to you for attachment to this policy there was mentioned anything with respect to the time or period that the party was to recognize Otis & Browne as insurance brokers?

A. Well, the letter named the insurance brokers from that date on. [22]

Q. It said something to the effect from that date on? A. Yes.

Q. I see. Do you remember anything else with respect to what was in that letter?

A. In what way?

Q. Is that about the extent of what was said or do you recall anything else with regard to it?

A. Just asking the Merchants Fire to recognize

(Testimony of Fletcher Quinn Ritch.)

Otis & Browne, Incorporated, as their insurance brokers.

Q. Do you recall whether it was on a letterhead or plain form? A. Recall what?

Q. Whether it was on a letterhead or plain form? A. No, I don't.

Mr. Taylor: You don't. That is all.

The Court: Any further questions?

Mr. Hauerken: No further questions.

The Court: That is all.

Mr. Taylor: That is all, Mr. Tich.

Q. Now, if your Honor please, in connection with the defendant's case that is all of the evidence at the present time. I wish to tender here in court a check of the Merchants Fire Assurance Company in the amount of \$209.36 covering the amount of premium as of April 10, 1946, with interest to date.

That is all. [23]

Mr. Hauerken: I don't know whether that is offered in evidence or to whom it is tendered or the exact purpose of it, and accordingly I don't know what I should say in response to this particular tender other than if it is tendered to the plaintiffs it is of course rejected.

Mr. Taylor: It is of course tendered to the plaintiffs, tendered in open court.

The Court: Well, it is not an exhibit.

Mr. Hauerken: It is nothing.

The Court: If it is tendered and rejected I assume it should now be returned to counsel that offered it.

Mr. Hauerken: I would like to call Mr. Browne.

EDWARD RAMBO BROWNE
recalled for the plaintiffs, previously sworn.

Direct Examination

By Mr. Hauerken:

Q. Mr. Browne, your firm—I am going to lead on this, if I may, on what I deem to be immaterial.

Mr. Taylor: That is all right.

Q. (By Mr. Hauerken): Your firm caused to be prepared and presented to Merchants Fire Assurance Company this endorsement dated February 6, 1945, is that correct?

A. That is correct.

Q. Did Otis & Browne or you procure this particular Merchants Fire Assurance Company policy originally for the [24] plaintiffs in this case?

A. No.

Q. Now do you recall whether or not you personally, or do you recall who in your firm may have presented this endorsement of February 6, 1945, for the Merchants file?

The Court: First, did you?

A. It is possible, your Honor, that I could have. Of course, it is two years now—

Q. You have no independent recollection of whether you did or did not?

A. I probably did. Let's say for argument's sake that I did. The procedure, if I may tell my story—

The Court: No, confine yourself to answers to questions.

(Testimony of Edward Rambo Browne.)

Q. (By Mr. Hauerken): Now did you or your firm at the time that you prepared and presented this endorsement to the Merchants have a letter from the plaintiffs signed by A. A. Pagliero which you exhibited and showed to the Merchants Fire?

A. What kind of a letter?

Q. Well, a letter—

The Court: You heard it described a few minutes ago, did you not, by Mr. Ritch?

A. No, there was no such letter.

Q. (By Mr. Hauerken): Now with respect to this letter of [25] April the 10th that has been offered into evidence—

And by the way, may I say for the benefit of the court the fire we are talking about happened on May 22.

The Court: That is in the stipulation.

Mr. Hauerken: Yes.

The Witness: Mr. Hauerken, in view of all of these facts I would like to put in a few points if I may—

Mr. Hauerken: No, I think you can't do that—

The Witness: I am sorry.

Mr. Hauerken: You have to answer questions that counsel propound. If your answer is not fully explanatory, of course, I think you have the right to explain.

The Witness: Is there any law that requires me to answer either yes or no to a question?

(Testimony of Edward Rambo Browne.)

Mr. Hauerken: No, you may explain an answer if you feel a yes or no is not completely—

The Court: If the explanation is relevant.

Q. (By Mr. Hauerken): Now I am going to show you a letter dated April 10, 1945, marked Defendant's Exhibit B; when you received that letter did you inform any one at the Technical Porcelain of having received this letter?

A. Is this what is called the first letter?

Q. That is the first letter. Let me change the question. Did you inform any one at the Technical Porcelain of having received this letter at any time prior to the fire? [26] A. No.

Q. Now take the next letter, of May 3d, marked Defendant's Exhibit C, did you at any time inform any one at the Technical Porcelain of the receipt of that letter prior to the fire? A. No.

Q. Did you tell any one at the Technical Porcelain of the fact that you had procured a policy of the Home Fire & Marine Insurance Company in any amount; did you tell them that prior to the fire?

A. No.

Q. When did you tell any one of the Technical Porcelain of having procured a policy from the Home Fire & Marine Insurance Company in a like amount as the Merchants Fire Assurance Company policy?

A. Approximately a week after the fire.

Q. Who did you tell that to?

A. To Mr. Antone Pagliero.

Q. And he is one of the partners in the firm?

(Testimony of Edward Rambo Browne.)

A. So I understood.

Q. What did Mr. Pagliero say when you told him that?

A. Well, he says that adds up to 315,000.

Q. Did he approve of your having cancelled this policy or attempting to cancel the policy of Merchants, or did he disapprove? [27]

Mr. Taylor: Just a moment. Object to that on the ground that it is incompetent, irrelevant and immaterial. It does not make any difference whether the plaintiffs gave any approval at that time or not. The fire had occurred and the rights were determined—

Mr. Hauerken: Let me ask this: Do you reject the theory of ratification?

Mr. Taylor: Not by any means. We contend that the exercise of the rights under this policy was the ratification of the action of the brokers in obtaining the substitute policy.

The Court: Don't you think it is competent and material as to the question of ratification?

Mr. Taylor: Well, I take this view of it, that as far as ratification is concerned it is the rights that were exercised on that policy and not what he told his broker at that time. I take it what counsel is getting at, of course, is the position that the man was taking, his reasons for making claim under the new policy.

The Court: Well, I will receive it. Overruled.

Mr. Hauerken: Will you read the question, Mr. Reporter?

(Testimony of Edward Rambo Browne.)

(Question read.)

The Witness: Do I answer that?

Mr. Hauerken: Yes.

A. He didn't indicate that he wanted the Merchants policy [28] cancelled.

Q. Now, in your dealings with Mr. Pagliero's firm, have you ever cancelled or attempted to cancel any other policies of insurance through a similar procedure as in this case? A. No.

Q. What licenses does your firm hold from the State of California to engage in the insurance business?

A. We hold an insurance broker's license, Lloyd's license, life license, the usual things necessary.

Mr. Hauerken: Is your Honor familiar with the type of licenses under the Insurance Code?

The Court: Yes.

Q. (By Mr. Hauerken): You hold an insurance broker's license? A. Yes.

Q. But no insurance agent's license?

A. Yes, we have an insurance agent's license.

Q. I mean other than life insurance?

A. Yes, we have an insurance agent's license for the Employers Liability Assurance Corporation and the Employers Fire Insurance Company, but none other.

Q. But other than that is your business that of general brokers? A. Yes.

Mr. Hauerken: I think that is all. [29]

(Testimony of Edward Rambo Browne.)

Cross-Examination

By Mr. Taylor:

Q. Mr. Browne, you say that you took over the representation as an insurance broker of the plaintiffs in this case some time in December of 1944?

A. That is approximately correct.

Q. And as the questions have been brought out by Mr. Hauerken, prior to that time as to this particular policy a different broker had acted on it, isn't that so? A. That is true.

Q. And you were substituted in the place of that broker who had issued the policy and handled the plaintiff's insurance, is that correct?

A. Our firm was substituted.

Q. And you handled from and after that time their entire insurance portfolio, did you not?

A. That is true.

Q. It was not an appointment designating you for the issuance or the obtaining of any single policy, is that not so? A. That is true.

Q. As a matter of fact, you recall in this instance as to the premium on this policy as to whether it was paid by you or by the plaintiff to the defendant in this case?

A. The premium was not paid by our office because we did not procure the policy originally. You see, when we took [30] over we merely superimposed what we considered accurate and adequate coverage on an existing contract and there was no financial transaction and it had some time to run,—I think about a year and a half to go.

(Testimony of Edward Rambo Browne.)

Q. The presentation in situations such as you have here where you have taken over an insurance line from another broker—the presentation of letters from the assured under the policy or the policies in the schedule designating you an insurance broker—the presentation of letters to the company or companies on the schedule is a common practice in the insurance business, isn't it?

A. It is not always done. It is sometimes done. Whether it is common or usual I can't say. On this particular risk for this client there are some fourteen or fifteen companies and none of those fourteen or fifteen companies have copies of letters or any other record of presentation of letters from us.

Q. Would you say they had no record of any letters of presentation—

A. They were told that we had taken over and if they wanted to confirm it they could communicate with the original agents or brokers or with the property owner direct.

Q. It would be your recollection that you followed the same course as to all companies on the line and the Merchants the same way? [31]

A. That is true, and we have been in business for many years and my people before me and they have taken our word on these things.

Mr. Taylor: That is all.

Redirect Examination

By Mr. Hauerken:

Q. On the question of the usual practice that

(Testimony of Edward Rambo Browne.)

Mr. Taylor presented, is not the usual practice to secure a letter, why didn't you secure such a letter in this case?

A. The man who had previously handled the insurance in a brokerage capacity was named Meyer Lightner, Incorporated. Mr. Pagliero had a rather unpleasant and unfortunate experience and Meyer Lightner had received from Mr. Pagliero a letter similar to that which is under discussion and he found that his insurance was grossly mismanaged, in accordance with his findings and his opinion, and requested that Mr. Meyer or Lightner retire as his broker and Mr. Lightner refused because of the letter which was a binding contract between Pagliero and Lightner, and in order to get rid of Mr. Lightner Mr. Pagliero had to pay him a considerable sum to get him to relinquish his authority.

Q. As a matter of fact, Lightner sued Mr. Pagliero? A. That is true.

Q. And predicated on that suit, which in turn was predicated on the letter, Mr. Pagliero had to buy his peace? [32]

A. That is true. And in the light of everything that had transpired we felt it was rather bad taste for us to ask for a letter of appointment.

Q. And that is how you know you would have no letter in your file?

A. That is true. I searched my file at the request of Mr. Taylor of Thornton & Taylor and I informed Mr. Taylor that I had found no such letter, and that was quite some time ago.

(Testimony of Edward Rambo Browne.)

Mr. Hauerken: That is all.

The Court: You undoubtedly informed Mr. Ritch that your company had taken over the business as brokers, is that true? A. Yes.

Q. But you did that verbally? A. Yes.

Recross-Examination

By Mr. Taylor:

Q. Mr. Browne, the language used on Defendant's Exhibit No. C, the letter of May 3d, the notation at the bottom of that in pen and ink referring to policy having been replaced, that reference to policy replaced referred to the Home Fire & Marine policy that had been issued in the same amount, did it?

A. True, and I would like to call your attention to the fact that the letter previous to this which this is a followup of stated that if they received word from us to send a [33] cancellation notice they would do so, and this indicates that they may send their cancellation notice.

Mr. Taylor: That is all, your Honor.

Mr. Hauerken: That is all.

The Court: That is all.

ANTONE A. PAGLIERO

called for the plaintiffs, sworn.

Direct Examination

By Mr. Hauerken:

Q. Mr. Pagliero, what insurance broker procured this policy of the Merchants Fire Assurance Corporation for the Technical Porcelain & China-ware Company? A. Meyer Lightner Company.

(Testimony of Antone A. Pagliero.)

Q. Did Otis & Browne have anything to do with procuring this policy of Merchants?

A. No, sir.

Q. The Technical Porcelain & Chinaware Company is a co-partnership, is that correct?

A. Yes.

Q. And the partners consist of John Pagliero, your father; Arthur Pagliero, your brother; and yourself, is that correct? A. Yes.

Q. Is your father rather elderly? A. Yes.

Q. And your brother is younger than you? [34]

A. Yes, sir.

Q. Who is actively in charge of the operations of the company?

A. I have been since 1922.

Q. And who has been actively in charge of matters of insurance?

A. I have been, sir. Due to our past experience on a fire we had—I think the first small fire we had was in 1937—so I had been fully responsible for all insurance policies.

Q. As a result of that fire in 1937 you became quite insurance-minded? A. Yes, sir.

Q. Realizing the importance of it? A. Yes.

Q. Now did your company ever receive any notice of cancellation of the Merchants Fire Assurance policy? A. We have not.

Mr. Taylor: Just a moment. Your Honor, there is no issue as to that. This would be irrelevant.

The Court: Overruled.

(Testimony of Antone A. Pagliero.)

The Witness: We haven't as yet, to this date, sir.

Q. (By Mr. Hauerken): Did you ever give any one authority to accept cancellation of any policy of insurance? A. No. [35]

Mr. Taylor: Objected to on the ground it is incompetent, irrelevant and immaterial.

The Court: Overruled.

A. No, sir.

Q. (By Mr. Hauerken): Did you ever give any one authority to accept the cancellation of the Merchants Fire Assurance policy? A. No, sir.

Mr. Taylor: Same objection, if your Honor please, and on the ground it calls for an opinion and conclusion of the witness.

The Court: Sustained on that ground, it calls for a conclusion.

Mr. Hauerken: If your Honor please, I think he testified he handled all the insurance policies in the firm. He would know whether or not he ever gave any one authority.

The Court: Well, it is a conclusion as to whether or not he did, but what he said or what he wrote would be the evidence on which the Court would draw the conclusion.

The Witness: Pardon me, I don't think I understand that.

Q. (By Mr. Hauerken): That is all right. We will bring that out. When were you notified by Mr. Browne of the fact of his having received some correspondence from the Merchants Fire and that

(Testimony of Antone A. Pagliero.)

another policy in a similar amount had been [36] taken out?

A. I would say about a week or ten days after our fire of May 22, 1946.

Q. What did you say when Mr. Browne told you about that?

Mr. Taylor: Objected to, if your Honor please, on the ground it is hearsay and incompetent, irrelevant and immaterial.

The Court: Sustained.

Q. (By Mr. Hauerken): Did you approve of any cancellation of the Merchants policy?

A. No, sir.

The Court: You had heard nothing about these letters that have been referred to prior to the time of the fire? A. No, sir.

Q. (By Mr. Hauerken): And when you did you took the matter up with me?

A. I took the matter up with my attorney, Mr. Hauerken.

Q. And asked me what your legal rights in the matter were? A. That is right, sir.

Q. And that was after the fire?

A. Yes, sir.

Q. You never returned the policy to the company but kept it either in your possession or my possession at all times after the fire? [37]

A. Yes, sir.

Q. Did you ever give Otis & Browne a general authority to handle your insurance to do as they saw fit?

(Testimony of Antone A. Pagliero.)

Mr. Taylor: Just a moment. Objected to upon the ground it is incompetent, irrelevant and immaterial, leading and suggestive, and calling for an opinion and conclusion of the witness.

The Court: It is both leading and suggestive and calling for a conclusion. Sustained.

Q. (By Mr. Hauerken): Did you ever give Otis & Browne any writing with respect to your insurance?

A. No, sir, for the simple reason of the experience we had with Myer Lightner Company and the suit we had with Myer Lightner Company.

Q. Myer Lightner were your previous brokers?

A. That is right.

Q. And you had given them some sort of a letter?

A. That is right, appointing them as exclusive brokers, and we had some misunderstanding on that, so I in turn took it upon myself that I would never give anybody exclusive broker rights.

Q. And Myer Lightner sued you?

A. That is right.

Q. And we compromised that suit?

A. That is right. [38]

Q. And that is the reason you wouldn't give any letter to Otis & Browne or any one else?

A. That is right, sir.

Mr. Hauerken: That is all.

Mr. Taylor: No questions.

Mr. Hauerken: That is our rebuttal on the affirmative defense.

The Court: Both sides rest now?

Mr. Taylor: Yes, your Honor.

Mr. Hauerken: May I suggest this, your Honor: There are a number of cases that touch upon this point and I think that perhaps better law work and better assistance can be given to the Court if briefs were filed, and I suggest that to you.

Mr. Taylor: Whatever suits your convenience, your Honor, I am prepared to do.

The Court: Well, of course you gentlemen have gone in this and the law involved as I have not had the opportunity to do, and I would like to have the advantage of what efforts you have made. If you think you can do it more advantageously by Memorandum, it is satisfactory to me.

(Thereupon, after further discussion, the matter was ordered submitted on briefs 10, 10 and 5, Mr. Taylor to have the opening and closing.) [39]

Certificate of Reporter

I, Clarence F. Wight, Official Reporter, certify that the foregoing 39 pages comprise a true and correct transcript of the matter therein contained as reported by me and thereafter reduced to type-writing, to the best of my ability.

/s/ CLARENCE F. WIGHT.

[Endorsed]: No. 11831. United States Circuit Court of Appeals for the Ninth Circuit. Antone A. Pagliero, John B. Pagliero and Arthur J. Pagliero, Copartners, Doing Business Under the Fictitious Firm Name and Style of Technical Porcelain & Chinaware Company, Appellants, vs. Merchants Fire Assurance Corporation of New York, a Corporation, Appellee. Transcript of Record. Upon Appeal from the District Court of the United States for the Northern District of California, Southern Division.

Filed January 14, 1948.

/s/ PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

In the United States Circuit Court of Appeals
for the Ninth Circuit

No. 11831

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, copartners
Doing Business Under the Fictitious Firm
Name and Style of TECHNICAL PORCE-
LAIN & CHINAWARE COMPANY,

Appellants,

vs.

MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK, a Corporation,
Appellee.

**APPELLANTS' DESIGNATION OF PARTS
OF RECORD NECESSARY FOR CONSID-
ERATION AND TO BE PRINTED**

In accordance with the provisions of Rule 19 (6) of the Rules of the above-entitled Court, appellants Antone A. Pagliero, John B. Pagliero and Arthur J. Pagliero, copartners doing business under the fictitious firm name and style of Technical Porcelain & Chinaware Company, hereby designate as the parts of the record necessary for consideration and to be printed each and every part, with the exception hereinafter noted, of the record certified to the above-entitled Court by the Clerk of the United States District Court, in and for the Southern Division of the Northern District of California, and designated in Appellants' Designation of Por-

tions of Record, Proceedings, and Evidence to be Contained in Record on Appeal heretofore filed with the Clerk of the United States District Court, in and for the Southern Division of the Northern District of California.

Of the four original exhibits certified to the above-entitled Court by said Clerk, the following only are hereby designated as part of the record necessary for consideration and to be printed:

- (1) The following portion of plaintiffs' Exhibit No. 1:

“Cancellation. This policy shall be cancelled at any time at the request of the insured, in which case the company shall, upon surrender of this policy, refund the excess of paid premium above the customary short rates for the expired time. This policy may be cancelled at any time, without tender of unearned portion of premium, by the company by giving five (5) days' written notice of cancellation to the insured and to any mortgagee or other party to whom, with the written consent of the company, this policy is made payable, in which case the company shall, upon surrender of the policy or relinquishment of liability thereunder, refund the excess of paid premium above the pro rata premium for the expired time.”

- (2) Defendant's Exhibit B.
- (3) Defendant's Exhibit C.

In addition to said record appellants further designate as part of the record necessary for consideration and to be printed.

(1) This Designation.

(2) Appellants' Statement of Points Relied Upon
On Appeal filed in the above-entitled Court.

/s/ GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,
Attorneys for Appellants.

Receipt of a copy of the foregoing Designation
is hereby admitted this 14th day of January, 1948.

THORNTON & TAYLOR,
Attorneys for Appellee.

[Endorsed]: Filed Jan. 14, 1948.

[Title of Circuit Court of Appeals and Cause.]

**APPELLANTS' STATEMENT OF POINTS
RELIED UPON ON APPEAL**

Appellants Antone A. Pagliero, John B. Pagliero and Arthur J. Pagliero, copartners, doing business under the fictitious firm name and style of Technical Porcelain & Chinaware Company, refer to points (1) to (5), inclusive, of Appellants' Statement of Points Relied Upon On Appeal heretofore filed with the Clerk of the United States District Court, in and for the Southern Division of the Northern District of California, and certified to the above-entitled Court by said Clerk as part of the record on appeal, and adopt the same as their Statement of Points Relied Upon on Appeal in accordance with the provisions of Rule 19 (6) of the Rules of the above-entitled Court.

/s/ **GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,**
Attorneys for Appellants.

Receipt of a copy of the foregoing Statement Of Points is hereby admitted this 14th day of January, 1948.

THORNTON & TAYLOR, AM,
Attorneys for Appellee.

[Endorsed]: Filed Jan. 14, 1948.

[Title of Circuit Court of Appeals and Cause.]

STIPULATION, APPLICATION FOR ORDER,
AND ORDER DISPENSING WITH
PRINTING OF EXHIBIT

Whereas various exhibits were introduced in evidence at the trial of the above-entitled action in the District Court of the United States, in and for the Southern Division of the Northern District of California; and

Whereas said exhibits were transmitted in their original form by the Clerk of said District Court to the Clerk of the above-entitled Court as part of the record on appeal in said action; and

Whereas plaintiffs' and appellants' Exhibit No. 1, being the insurance policy upon which said action was brought, is composed of:

- (1) The printed California Standard Form Fire Insurance Policy, and
- (2) Various printed and/or mimeographed and/or typewritten endorsements; and

Whereas it is deemed by the parties hereto that the effect, relationship and relative importance of the various clauses and endorsements of said policy will be made clearer to the above-entitled Court by an examination of the original of said policy than by an examination of a printed copy thereof:

Now, Therefore, it is hereby stipulated by and between the parties hereto, through their respective counsel, that no part of plaintiffs' and appellants'

Exhibit No. 1 need be printed into the record on appeal, and that the whole of said Exhibit may, in its original form, be deemed a part of the record on appeal which will be considered by the above-entitled Court for the purpose of the determination of the appeal in said action.

Pursuant to the foregoing Stipulation, the parties thereto hereby respectfully apply for an Order dispensing with the printing of said Exhibit No. 1 and in lieu thereof making the whole of said Exhibit, in its original form, a part of the record on appeal which will be considered by the above-entitled Court for the purpose of the determination of the appeal in said action.

Dated: San Francisco, California, this 28th day of January, 1948.

/s/ GEORGE H. HAUERKEN,
HAUERKEN, AMES &
ST. CLAIR,
Attorneys for Appellants.

/s/ EVANS M. TAYLOR,
/s/ THORNTON R. TAYLOR,
Attorneys for Appellee.

It Is So Ordered.

Dated: San Francisco, California, this 28th day of January, 1948.

/s/ FRANCIS A. GARRECHT,
United States Circuit Judge.

[Endorsed]: Filed Jan. 29, 1948.

No. 11,831

IN THE

United States Circuit Court of Appeals
For the Ninth Circuit

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, co-partners
doing business under the fictitious firm
name and style of Technical Porcelain
& Chinaware Company,

Appellants,

vs.

MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK (a corporation),

Appellee.

APPELLANTS' OPENING BRIEF.

GEORGE H. HAUERKEN,
HAUERKEN, AMES & ST. CLAIR,
535 Russ Building, San Francisco 4, California,
Attorneys for Appellants.

F I L E D

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Subject Index

| | Page |
|---|------|
| Jurisdiction of the District Court and of this honorable court | 2 |
| Statement of the case | 3 |
| Specification of errors | 6 |
| Argument | 10 |
| (1) The court erred in finding and holding that the acts of Otis & Browne were performed within the scope and authority of their employment as Pagliero's insurance brokers | 10 |
| (2) The court erred in admitting in evidence defendant's Exhibits B and C, as these exhibits were not shown to have been sent by Merchants to an agent of Pagliero authorized to receive and act upon them | 17 |
| (3) The court erred in holding that Pagliero ratified the acts of Otis & Browne and the replacement of one policy by the other | 18 |
| (4) The court erred in holding that there was a "substitu- tion" of one policy for the other..... | 21 |
| Conclusion | 32 |

Table of Authorities Cited

| Cases | Pages |
|--|------------|
| Arnfeld v. Guardian Assurance Company of London, 172 Pa. 605, 34 Atl. 580 | 24, 25, 31 |
| Baker v. North River Insurance Company (1923), 112 Kan. 530, 212 Pac. 118 | 30 |
| Christian v. Rice Growers Assn., 50 Cal. App. (2d) 617, 123 P. (2d) 534 | 14 |
| Cronenwett v. Iowa Underwriters etc. Co., 44 Cal. App. 571, 186 Pac. 824 | 13 |
| Emery v. Pacific Employers Ins. Co., 8 Cal. (2d) 663, 67 P. (2d) 1046 | 13 |
| Finley v. New Brunswick Fire Ins. Co., 193 Fed. 195 | 23, 24, 26 |
| Finley v. Western Empire Ins. Co., 69 Wash. 673, 125 Pac. 1012 | 23, 24, 25 |
| Glickman v. New York Life Ins. Co., 16 Cal. (2d) 626, 107 P. (2d) 252 | 22, 23 |
| Hansen v. Farmers Auto. Inter-Ins. Exch., 139 Cal. App. 388, 34 P. (2d) 188 | 14 |
| Hendricks v. Continental Insurance Company of City of New York, (1936), 121 Pa. Super. 393, 183 Atl. 363 | 31 |
| Hooker v. American Indemnity Co., 12 Cal. App. (2d) 116, 54 P. (2d) 1128 | 13 |
| Kavanaugh v. Franklin Fire Ins. Co., 185 Cal. 307, 197 Pac. 99 | 22, 23 |
| Lauman v. Conecordia Fire Insurance Company, 50 Cal. App. 609, 195 Pac. 951 | 12, 15, 18 |
| Lauman v. Springfield Fire etc. Ins. Co., 184 Cal. 650, 195 Pac. 50 | 13, 32 |
| New Zealand Insurance Company v. Larson Lumber Company, 13 F. (2d) 374 | 28 |

| | Pages |
|---|--------|
| Pacific Ready-Cut Homes, Inc. v. Seeber, 205 Cal. 690, 272 Pac. 579 | 14 |
| Peterson v. Hartford Fire Insurance Company (1903), 111 Ill. App. 466 (reversed on other grounds in 209 Ill. 112, 70 N. E. 757) | 30 |
| Phoenix Insurance Company v. Kerr, 129 Fed. 723 | 30 |
| Quong Tue Sing v. Anglo-Nevada Assur. Corp., 86 Cal. 566, 25 Pac. 58 | 13, 32 |
| Royal Exchange Assurance of London v. Luttrell, 99 Colo. 492, 63 P. (2d) 1240 | 29 |
| Scheel v. German American Insurance Company (1910), 228 Pa. 44, 76 Atl. 507 | 25, 31 |
| Speegle v. Board of Fire Underwriters, 29 Cal. (2d) 34, 172 P. (2d) 867 | 22 |
| Stevenson v. Sun Insurance Office, 17 Cal. App. 280, 119 Pac. 529 | 28 |
| Strauss v. Dubuque Fire & Marine Insurance Company, 132 Cal. App. 283, 22 P. (2d) 582 | 27, 28 |
| Tarleton v. DeVeuve (C.C.A. 9th), 113 Fed. (2d) 290 | 13, 32 |
| White v. Insurance Company of New York (1899), 93 Fed. 161 | 26 |
| Wilson v. National Ben Franklin Fire Insurance Company (1924) (Mo. App.), 246 S. W. 338..... | 29 |

Statutes

28 U. S. Code:

| | |
|---------------------|---|
| Section 41(1) | 2 |
| Section 71 | 2 |
| Section 225 | 2 |
| Section 345 | 2 |

No. 11,831

IN THE

**United States Circuit Court of Appeals
For the Ninth Circuit**

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, co-partners
doing business under the fictitious firm
name and style of Technical Porcelain
& Chinaware Company,

Appellants,

vs.

MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK (a corporation),

Appellee.

APPELLANTS' OPENING BRIEF.

This is an appeal to the United States Circuit Court of Appeals for the Ninth Circuit, from a final judgment of the United States District Court for the Southern Division of the Northern District of California.

**JURISDICTION OF THE DISTRICT COURT AND OF
THIS HONORABLE COURT.**

This action was originally brought by appellants in the Superior Court of the State of California, in and for the County of Contra Costa, to recover upon a policy of fire insurance issued to appellants by appellee. Upon petition of appellee it was subsequently removed to the District Court, presumably under Section 71, 28 U. S. Code. The action being of a civil nature, the parties citizens of different states, and the amount in controversy in excess of \$3000.00, exclusive of interest and costs,¹ the District Court had jurisdiction under Section 41(1), 28 U. S. Code.

The appellate jurisdiction of this Honorable Court rests upon Section 225, 28 U. S. Code, which gives the Circuit Courts of Appeals of the United States jurisdiction to review by appeal final decisions of the District Courts in all cases save where direct review may be had in the Supreme Court under Section 345, 28 U. S. Code. No direct review of this case can be had in the Supreme Court under Section 345, 28 U. S. Code.

The notice of appeal to this Honorable Court (see p. 31 of printed record) was filed on December 5, 1947, within thirty days of the entry of the judgment in the District Court.

¹See complaint, page 2 of printed record.

STATEMENT OF THE CASE.

In June, 1944, appellee, who will hereinafter sometime be referred to as Merchants, issued a policy of fire insurance to appellants, who will hereinafter sometime be referred to as Pagliero. The policy was in the amount of \$15,000.00, and was to run for a term of three years. In the early part of 1945, Otis & Browne, Inc., became Pagliero's insurance brokers and, in February of that year, acting as such brokers, they caused Merchants to modify rather extensively the coverage of the policy previously issued by Merchants to Pagliero. It may in fact be said that Otis & Browne procured for Pagliero what amounted to a new policy. At about the same time, and still acting as Pagliero's brokers, Otis & Browne either procured entirely new policies for Pagliero in companies in which Pagliero had previously not been insured, or caused companies in which Pagliero was insured at the time to modify the coverage of their policies as had been done by Merchants.

The policy, like all California standard form fire insurance policies, contained a cancellation clause providing that it might be cancelled by Merchants "by giving five (5) days' written notice of cancellation *to the insured*". (Italics supplied.) It admittedly contained no other clause under which it could in any other way be cancelled by Merchants.

For the next fourteen months Merchants had no dealings whatever with either Pagliero or Otis & Browne. On April 10, 1946, however, Merchants wrote to Otis & Browne asking them to cancel the policy.

That letter remained unanswered and Merchants accordingly wrote again to Otis & Browne on May 3, 1946, asking them to "follow up" on the letter of April 10th. Otis & Browne then answered that Merchants could "close your file" as the policy had been "replaced as of April 10, 1946". Upon receipt of Merchants' first letter, Otis & Browne had in fact procured from the Home Fire and Marine Insurance Company a policy in Pagliero's name covering the same property and in the same amount as that of Merchants.

Pagliero did not learn until *after* May 22, 1946, that Merchants had requested Otis & Browne to "cancel" and that Otis & Browne had "replaced" the policy. On that day, however, the insured property was damaged by fire in the sum of almost \$465,000.00. To cover that loss Pagliero had policies which, including the policy of Merchants and that of the Home Fire and Marine Insurance Company, amounted to a total face value of \$315,000.00.

Pagliero made claim under all policies and the Home Fire and Marine Insurance Company paid its share of the loss. Merchants, however, denied liability under its policy on the ground that it had been cancelled before the fire, and this action ensued.

Merchants admittedly did not comply with the cancellation clause. Since Pagliero's right to recover depends upon whether or not the policy was in effect at the time of the fire and since the policy contained no other clause under which it could in any other way be cancelled by Merchants, Pagliero can be said to have

made a *prima facie* case by establishing that he was not given by Merchants the five days' written notice of cancellation provided for in the policy. In an attempt to overcome this *prima facie* case, Merchants raised certain issues by way of an affirmative defense. It was stipulated before the trial that these issues were the only issued involved and, as to them, the burden of proof was of course upon Merchants.

Thus, the case was virtually tried on an agreed statement of facts, with the issues stipulated to be as follows:

1. The extent of the authority of Otis & Browne, Inc. as insurance brokers for plaintiff.
2. The legal effect of the acts and conduct of Otis & Browne, Inc. in obtaining a policy of insurance in a similar amount on the same property with the Home Fire & Marine Insurance Co., after their receipt of defendant's request for cancellation of its policy.
3. The legal effect of plaintiffs' having made claim for and having collected the full amount due under the said policy of the Home Fire & Marine Insurance Co."

(See printed record, p. 15.)

The trial Court gave judgment for Merchants after finding that all the acts of Otis & Browne were performed within the scope and authority of their employment as Pagliero's insurance brokers. The Court concluded that there had been a "substitution" of

policies and that the policy of Merchants was no longer in effect at the time of the fire.

The Court also concluded that Pagliero ratified after the fire the acts of Otis & Browne and the "substitution" of one policy for the other, without making it clear, however, how acts performed by an agent *within* the scope and authority of his employment can be *ratified* by the principal.

It is appellants' contention that the acts of Otis & Browne were not performed within the scope and authority of their employment; that they were not ratified after the fire; that there was no "substitution" of policies, and that the policy of Merchants was in effect at the time of the fire.

SPECIFICATION OF ERRORS.

(1) The Court erred in finding and holding that the acts of Otis & Browne were performed within the scope and authority of their employment as Pagliero's insurance brokers.

(2) The Court erred in admitting in evidence defendant's Exhibits B and C, as these exhibits were not shown to have been sent by Merchants to an agent of Pagliero authorized to receive and act upon them.

Exhibit "B" is as follows:

“(Letterhead) Merchants Fire Assurance
Corporation of New York
April 10, 1946

Otis & Browne, Inc.
233 Sansome Street
San Francisco, Calif.

Gentlemen:

Re: Policy #8604
Technical Procelain Co.

Will you kindly cancel this policy and return it to us for pro rata cancellation?

The Company has requested us to retire from the liability because we are no longer willing to accept this classification. If you would prefer, we can send cancellation notice direct to the assured. However, we will not do so unless you specifically instruct us.

Yours very truly,
/s/ H. F. Rohrbach
Manager”

(p. 54 of printed record.)

Exhibit “C” is as follows:

“(Letterhead) Merchants Fire Assurance
Corporation of New York
May 3, 1946

Otis & Browne, Inc.,
233 Sansome St.,
San Francisco, Calif.

Gentlemen:

Re: Policy #8604
Technical Porcelain Co.

We are following up a letter written to you on April 10 asking for cancellation of this policy.

We understood that you were going to relieve us of liability as soon as possible although no definite date was set for the termination.

Will you kindly follow this up and endeavor to have our policy returned within the next ten days?

Yours very truly,
/s/ H. F. Rohrbach,
Manager

(Notation): You may close your file as this has been replaced as of April 10, 1946. Policy is at Mechanic's Bank, Richmond, and will require some time to secure unless you wish to send cancellation notice dated 10 days prior to April 10, 1946."

(p. 56 of printed record.)

The following objections were made by Pagliero to the admission of Exhibit "B":

"Mr. Hauerken. We object to the relevancy of that document, your Honor. I refer your Honor to the case of Lauman v. Concordia Fire Insurance Co., in which it was held substantially that a firm whose practice and custom, in relation to the cancellation of insurance policies, is to protect the assured in some other company, if possible, and to notify him of the cancellation of his policy by either sending him a new policy or advising him that they cannot replace it, and requesting a return of the policy, are mere brokers, and as such are without authority to accept notice of cancellation.

And the case goes on further to say that an agency to procure insurance is ended when the

policy is procured and delivered to the principal, and the agent has no power after the policy is so delivered to consent to a cancellation, or to accept notice of an intended cancellation by the insurer; and that the evidence of usage to give notice to a broker is inadmissible where the policy requires notice to the insured.

There are a number of cases on that point. I just cited one to show the attempt to cancel through the medium of a broker is legally without effect.

The Court. The objection is overruled."

(pp. 52-53 of printed record.)

The same objection was made by Pagliero to the admission of Exhibit "C":

"The Court. I presume you make the same objection?

Mr. Hauerken. The same objection as to the last document.

The Court. Overruled. Received."

(p. 56 of printed record.)

(3) The Court erred in holding that Pagliero ratified the acts of Otis & Browne and the replacement of one policy by the other.

(4) The Court erred in holding that there was a "substitution" of one policy for the other.

ARGUMENT.

(1) **THE COURT ERRED IN FINDING AND HOLDING THAT THE ACTS OF OTIS & BROWNE WERE PERFORMED WITHIN THE SCOPE AND AUTHORITY OF THEIR EMPLOYMENT AS PAGLIERO'S INSURANCE BROKERS.**

There is no evidence in the record tending to show that Otis & Browne were either specifically or generally authorized to do those acts. Nor is there any evidence in the record tending to show that they were general insurance agents for Pagliero. On the contrary, the only evidence in the record shows that they were only Pagliero's insurance brokers. As such, and without prior additional authority, they were *not* authorized to do the acts which the Court found that they were authorized to do.

There is some conflict in the evidence on the question of whether written authority was given Otis & Browne by Pagliero. Mr. Browne, President of Otis & Browne, testified that no such authority was given. Mr. Pagliero, appellants' managing partner, testified that no such authority was given. The credibility of his testimony to that effect is enhanced by his testimony as to his reasons for not giving his new brokers any written authority. Mr. Pagliero testified as follows:

"Q. (by Mr. Hauerken). Did you ever give Otis & Browne any writing with respect to your insurance?

A. No, sir, for the simple reason of the experience we had with Myer Lightner Company and the suit we had with Myer Lightner Company.

Q. Myer Lightner were your previous brokers?

A. That is right.

Q. And you had given them some sort of a letter?

A. That is right, appointing them as exclusive brokers, and we had some misunderstanding on that, so I in turn took it upon myself that I would never give anybody exclusive broker rights.

Q. And Myer Lightner sued you?

A. That is right.

Q. And we compromised that suit?

A. That is right.

Q. And that is the reason you wouldn't give any letter to Otis & Browne or any one else?

A. That is right, sir."

(See printed record p. 75.)

As against the testimony of the two persons who knew best, Merchants produced the testimony of its underwriter who *thought* that he remembered having been shown in February, 1945, some written authorization given Otis & Browne by Pagliero. That conflict, however, does not have to be resolved, for it is a conflict only as to whether a writing was given. On the more important question of the extent of Otis & Browne's authority, whether it be written or not, the evidence is without conflict. *The underwriter himself* was quite specific as to the contents of the writing allegedly shown him by Otis & Browne; that writing *went no further than to appoint them Pagliero's insurance brokers.* (See printed record p. 60.)

It is of course admitted that Otis & Browne were Pagliero's insurance *brokers* at the time. There is,

however, no evidence that they were, as Merchants contended in the trial Court and will undoubtedly contend before this Honorable Court, "general insurance agents" for Pagliero. On the contrary, the evidence shows without conflict that they were not such general insurance agents. From the evidence in the record, and it must be remembered that upon that issue the burden of proof is upon Merchants, it cannot possibly be inferred that the actual authority given Otis & Browne was broader.

The question then presents itself as to whether an insurance broker, whom his principal simply empowers to procure a policy, becomes by operation of law empowered to cancel that policy. It is well settled that the law does not increase his authority, as Merchants would have it increased, and that he remains empowered to do only what his principal authorizes him to do and no more.

Since the present case is before this Court simply on the ground of diversity of citizenship, the California law is the applicable law. In the case of *Lauman v. Concordia Fire Insurance Company*, 50 Cal. App. 609, 195 P. 951, the defendant insurance company contended, as Merchants does in this case, that its policy had been cancelled before the fire. The answer to that contention depended upon the extent of the authority of plaintiff's broker, to whom the company had given notice of cancellation. The Court held that the broker was not authorized to receive notice of cancellation on the ground that "*an agency to procure insurance is ended when the policy is pro-*

cured and delivered to the principal, and the agent has no power after the policy is so delivered to consent to a cancellation or to accept notice of an intended cancellation by the insurer." (50 Cal. App. at p. 618; italics supplied; to the same effect are: *Emery v. Pacific Employers Ins. Co.*, 8 Cal. (2d) 663, 672, 67 P. (2d) 1046; *Quong Tue Sing v. Anglo Nevada Assur. Corp.*, 86 Cal. 566, 571, 25 Pac. 58; *Lauman v. Springfield Fire etc. Ins. Co.*, 184 Cal. 650, 652, 195 Pac. 50; *Hooker v. American Indemnity Co.*, 12 Cal. App. (2d) 116, 120; 54 P. (2d) 1128; *Cronenwett v. Iowa Underwriters etc. Co.*, 44 Cal. App. 571, 575, 186 Pac. 824; *Tarleton v. DeVeuve* (C.C.A. 9th), 113 Fed. (2d) 290, 299.) In the *Quong Tue Sing* case, cited supra, the Court used language which seems made to order for the present case:

"There is an entire lack of any evidence even tending to show that Brandon (the broker) had any authority * * * to accept a cancellation of it on any terms, unless such agency is established by a mere showing that he was the appellant's agent in procuring the insurance. That an agent authorized to procure insurance is not thereby made the agent of the insured to cancel the policy is well settled."

(86 Cal. at 571.)

Nor can it be contended that Otis & Browne had at least ostensible authority to act upon a request for cancellation or to otherwise agree to a cancellation of the policy. It is elementary that the question of whether an agent has ostensible authority to do a certain act is to be determined by the conduct or dec-

larations of the principal and not by the conduct or declaration of the agent. (*Pacific Ready-Cut Homes, Inc. v. Seeber*, 205 Cal. 690, 694, 272 Pac. 579; *Hansen v. Farmers Auto. Inter-Ins. Exch.*, 139 Cal. App. 388, 393, 34 P. (2d) 188; *Christian v. Rice Growers Assn.*, 50 Cal. App. (2d) 617, 621, 123 P. (2d) 534.) We must accordingly again look at the facts to determine what may have been done or said by Pagliero that led Merchants to believe that Otis & Browne were authorized to do more than procure a modified policy from Merchants. The most that was done by Pagliero was to give Otis & Browne written authority to act as his insurance brokers. That written authority (if any there was) was shown to Merchants and Merchants was accordingly led to believe that Otis & Browne were authorized, as in fact they were, to procure for Pagliero a modified policy of fire insurance. Pagliero did nothing else in the next sixteen months that might lead Merchants to believe that Otis & Browne had any broader authority. In fact Pagliero had no dealings whatever with Merchants until after the fire. Nor did Otis & Browne themselves have any dealings with Merchants, with respect to Pagliero's policy, for the fourteen months that followed their procurement of a modified policy. On April 10, 1946, however, a letter was sent; not by Pagliero to Merchants; not by Otis & Browne, purporting to act for Pagliero, to Merchants; but by Merchants to Otis & Browne. In other words, fourteen months after Otis & Browne had procured a policy for Pagliero, Merchants sought them out with a request that that policy be cancelled.

Merchants now contends that it was led to believe that the extent of Otis & Browne's authority was much broader than it was in fact. We have shown that Pagliero did nothing to lead Merchants to such a belief and that such a belief would have been justified only to the extent that it was induced by Pagliero. We now propose to show that, in April and May, 1946, Merchants itself did not believe that Otis & Browne were authorized to act upon a request for cancellation or otherwise agree to a cancellation of the policy. All that Merchants knew was that Otis & Browne were Pagliero's brokers and that as such they had been authorized, fourteen months previously, to procure a modified policy for Pagliero. Merchants also knew the law applicable to such a situation and was undoubtedly familiar with the case of *Lauman v. Concordia Fire Insurance Company*, cited supra, and the numerous other cases to the same effect. On April 10, 1946, knowing the facts and the law applicable to those facts, Merchants wrote to Otis & Browne asking them to cancel the policy. Had the letter been sent directly to the assured or to an agent of the assured authorized to receive a notice of cancellation, it would simply have said that the policy would be cancelled five days after the receipt of the letter. Had the letter been sent to an agent authorized to receive notice of cancellation, Merchants would not have added:

“If you would prefer, we can send cancellation notice direct to the assured.”

The letter of April 10, 1946, in effect told Otis & Browne that Merchants was aware that nothing could be done by Otis & Browne alone that would result in the cancellation of the policy, and that, to be effective, notice of the cancellation had to be given *to the assured*. Since the policy was procured or at least modified through Otis & Browne, Merchants may have felt that, from the standpoint of a sound business policy, Otis & Browne should not be by-passed. Accordingly, Merchants offered them an opportunity to break the news to the assured.

At this stage of our discussion of the case, we are not concerned with anything that may have been done by Otis & Browne following the receipt of that letter. It is sufficient to point out that they did not convey to Pagliero, until after the fire, the message which Merchants had asked them to convey.

On May 3, 1946, Merchants again wrote to Otis & Browne asking them to "follow up" on its letter of April 10th. Nothing in that second letter is evidence of any belief on the part of Merchants that it was writing to an agent of Pagliero whom Pagliero had previously authorized, either actually or ostensibly, to accept a notice of cancellation or otherwise agree to a cancellation of the policy. Under the terms of the policy, however, notice of cancellation was to be given to the assured *and to no one else*. Since Otis & Browne did not convey the message to Pagliero and since Pagliero never authorized them to receive such a message and keep it to themselves, the conclusion is in-

escapable that the cancellation clause was not complied with.

To complete the picture as to the extent of Otis & Browne's authority, there remains to be pointed out that nothing that Otis & Browne did or wrote as a result of either of Merchants' letters can be regarded as either increasing their actual authority or as giving them any ostensible authority which they previously did not possess. Finally, it may be noted that Otis & Browne never led Merchants to believe that its message had been conveyed. While their answer to Merchants' letter of May 3, 1946, advised Merchants that the policy had been "replaced" in effect it also notified Merchants that its message had not been conveyed to Pagliero and accordingly suggested that Merchants might "wish to send cancellation notice" to Pagliero.

(2) THE COURT ERRED IN ADMITTING IN EVIDENCE DEFENDANT'S EXHIBITS B AND C, AS THESE EXHIBITS WERE NOT SHOWN TO HAVE BEEN SENT BY MERCHANTS TO AN AGENT OF PAGLIERO AUTHORIZED TO RECEIVE AND ACT UPON THEM.

The letters sent by Merchants to Otis & Browne were admissible in evidence only if relevant and they obviously were relevant only if sent to an agent of Pagliero authorized to receive and act upon them, or if they had in fact been communicated to Pagliero before the fire. It is conceded that they were not communicated before the fire and we have shown that Otis & Browne did not have the requisite authority.

In *Lauman v. Concordia Fire Insurance Co.*, 50 Cal. App. 609, 195 Pac. 951, for example, after holding that a broker is not authorized to receive and act upon a notice of cancellation, the Court added that "evidence of a usage to give notice to a broker is inadmissible, where the policy requires notice to the insured." (50 Cal. App. at p. 618.) It seems clear that if evidence of such a usage is inadmissible, evidence of the giving of the notice itself is even less admissible.

(3) THE COURT ERRED IN HOLDING THAT PAGLIERO RATIFIED THE ACTS OF OTIS & BROWNE AND THE REPLACEMENT OF ONE POLICY BY THE OTHER.

There is no evidence in the record that Pagliero in fact ratified the cancellation of the policy of Merchants. On the contrary the record makes it clear that Pagliero emphatically expressed his intention not to ratify the cancellation. (See printed record p. 74.) The holding of the trial Court must accordingly be taken to mean either that the unauthorized procurement of the new policy by Otis & Browne automatically terminated the liability of Merchants on its policy, or that Pagliero was called upon to elect between the two policies and, as a matter of law, could not at the same time ratify Otis & Browne's unauthorized procurement of the new policy and decline to ratify their unauthorized cancellation of the old policy.

It is true that a well settled rule in the law of agency precludes a principal from retaining the bene-

fits of a transaction which his agent was not authorized to enter into, without at the same time shouldering the burden of that transaction. That rule, however, does not prevent Pagliero from retaining both policies. It is intended to protect the person with whom the agent dealt and means only that the principal must ratify the whole transaction *with that person* if he wishes to ratify any part of it. He cannot, for example, retain the proceeds of a sale and disclaim unauthorized warranties without which his agent could not have made the sale. Nor could Pagliero retain the benefits of the transaction between his brokers and The Home Fire and Marine Insurance Company without paying the price which his brokers contracted to pay for those benefits and without being bound by whatever warranties they made to induce that company to issue its policy. Nor could Pagliero ratify the transaction between his brokers and Merchants to the extent of making claim to a refund of the premium previously paid on Merchants' policy, without at the same time ratifying the cancellation of that policy upon which the right to a refund is based.

It is not contended, however, that Merchants sought to cancel its policy only on condition that Pagliero would procure another. On the contrary Merchants sought to cancel irrespective of whether Pagliero would be able to procure another policy. In fact, it is probable that Merchants' decision to cancel would have been bolstered, had it learned that no one else cared to insure Pagliero's property. Nor is it con-

tended that The Home Fire and Marine Insurance Company issued its policy only on the condition that Merchants' policy was no longer effective.² There is accordingly no connection whatever between the two transactions, except in the minds of Pagliero's brokers, who seem to have thought that they had to enter into one transaction to protect their principal from what they regarded as the effects of the other. The purpose of an agent who enters into an unauthorized transaction on behalf of its principal is, however, immaterial. The principal can ratify the transaction, irrespective of the agent's purpose, so long as that purpose was not, in some way, made a part of the transaction.

Moreover, it is not in their transaction with Merchants that Otis & Browne had the purpose upon which Merchants insists so much, but in their transaction with The Home Fire and Marine Insurance Company. It may well be that, if purposes were material, The Home Fire and Marine Insurance Company could contend that its policy was issued to replace that of Merchants and was accordingly to be effective only if a replacement was actually needed. No such contention can be made by Merchants, for it sought an unconditional cancellation of its policy, to which Otis & Browne unconditionally agreed, al-

²It must be emphasized that the present case is not a case of over-insurance, but a case of extreme under-insurance. Thus, it can neither be said that Pagliero is trying to recover more than his loss, nor that either Merchants or The Home Fire and Marine Insurance Company might have declined to insure Pagliero, had it known that he carried both policies, for fear that he might be careless about protecting his property from fire.

though they were not authorized to enter into such an agreement, conditionally or otherwise. No string was attached to that agreement when it was made. Accordingly Merchants cannot now tie it to another agreement and compel Pagliero to ratify or reject them together. It must stand or fall on its own, depending upon whether (1) Otis & Browne were authorized to enter into it, or (2) it was ratified by Pagliero.

(4) THE COURT ERRED IN HOLDING THAT THERE WAS A
“SUBSTITUTION” OF ONE POLICY FOR THE OTHER.

We must confess not to be certain whether the conclusion of the trial judge that there was a “substitution” of one policy for the other is a mere restatement of his finding that Otis & Browne were authorized to do what they did, or of his conclusion that Pagliero ratified what was done by Otis & Browne, or whether it is to be taken as a separate and distinct ground on which the trial judge rested his judgment. Nothing need be added to this brief, if “substitution” means only previous authority or ratification, for we have already established that in this case there was neither previous authority nor ratification. It is necessary to establish, however, that there is no separate and distinct doctrine of substitution in the law of insurance, and that the Court erred in so far as it purported to rely upon such a doctrine to support a judgment in favor of Merchants.

We already pointed out that the action is before this Court on the ground of diversity of citizenship.

There is accordingly no federal question involved and the applicable law is that of the State of California. Unfortunately, there are no California cases in point. It is true, that at the trial, Merchants purported to rely upon several California cases. None of these cases are in point, as we will show in our reply brief, should Merchants purport to rely upon them on appeal. Although persuasive authority must therefore be sought in other jurisdictions, it is well to remember certain basic principles of California insurance law, for they may help us determine which of several cases from other jurisdictions California would be most likely to follow.

It is now settled in California that a policy of insurance is to be regarded as a commodity rather than as an ordinary contract and that the rules of construction applicable to ordinary contracts do not apply to the construction of insurance policies. (*Kavanaugh v. Franklin Fire Ins. Co.*, 185 Cal. 307, 314, 197 Pac. 99; *Glickman v. New York Life Ins. Co.*, 16 Cal. (2d) 626, 632, 107 P. (2d) 252; *Speegle v. Board of Fire Underwriters*, 29 Cal. (2d) 34, 44, 172 P. (2d) 867.) In fact, a policy is now construed so strongly against the insurer, that a complete answer to Merchants' contention lies in the fact that Merchants itself provided that the only way in which it could cancel its policy would be by giving five days' written notice to the insured, thereby indicating that no other method would be sufficient, be it called "substitution" or any other name.

Both the trial Court and Merchants seem to have placed considerable reliance upon the case of *Finley v. New Brunswick Fire Ins. Co.*, 193 Fed. 195. This case was decided in 1911, long before the *Kavanaugh* and *Glickman* cases, cited supra. We need not emphasize that, although it is entitled to respect, being the decision of a District Court, it is not binding upon this Honorable Court. At first glance the case seems to announce a doctrine of "substitution" as broad as that contended for by Merchants. It then appears, however, that the three cases relied upon by the Court in support of that doctrine do not support it at all. These cases will be reviewed below. How much strength is thus left to the *Finley* case need not be determined, for it is, on its facts, distinguishable from our case on at least two grounds:

(a) As is made clear by a reading of the companion case of *Finley v. Western Empire Ins. Co.*, 69 Wash. 673, 125 Pac. 1012, *the agent to whom notice of cancellation was given was authorized to keep the property insured up to a certain amount*. His authority was accordingly much broader than that of Otis & Browne in our case. In fact, it was broad enough to support his agreement to cancel one policy and his procurement of another, so that the whole discussion of the District Court about ratification of the "substitution" appears to be at best pure dictum.

(b) The agent to whom the defendant in the *Finley* case gave notice of cancellation was *not only acting as broker for the plaintiff, but also as agent*

for the defendant; so that, when he procured a new policy for the plaintiff, he was protecting not only the plaintiff, but also the defendant, and the new contract was accordingly subject to the condition that the plaintiff relinquish the old one. In our case, however, Otis & Browne were not Merchants' agents, so that by no stretch of the imagination can it be said that the contract with the Home Fire & Marine Insurance Company was subject to the condition that Pagliero relinquish his contract with Merchants, or that Pagliero did relinquish that contract by making claim under the Home Fire and Marine policy.

Moreover, the Court was undoubtedly influenced in the *Finley* case by the fact that the plaintiff was over-insured; in our case, however, Pagliero will have at most three hundred fifteen thousand (\$315,000.00) dollars to cover a loss of over four hundred sixty thousand (\$460,000.00) dollars. In the final analysis, however, it must be conceded that *some of the language in the Finley case, as distinguished from the holding in the case*, which we have shown not to be in point, supports Merchants' position. To the extent that it does support that position, we believe it to be as unsound as we have shown that position to be when we previously analyzed it.

The case of *Arnfeld v. Guardian Assurance Company of London*, 172 Pa. 605, 34 Atl. 580, is the first case relied upon by the District Court in *Finley v. New Brunswick Fire Ins. Co.* That case, decided in 1896, seems to be a case in which the assured was trying to recover more than his loss. Although the

facts are not very clear, it appears that the assured was denied recovery against the first company (Merchants in our case), after having collected from the second company (The Home Fire & Marine Ins. Co. in our case), on the ground that "no party ought to be allowed to recover twice for the same debt". (34 Atl. at 581.) The case is further distinguishable on the ground that "*he (the agent) acted throughout for the plaintiffs and for both companies, and communicated with both; and all consented, and ratified his acts*". (34 Atl. at 581. Italics supplied.) The opinion does not disclose the extent of the agent's authority, nor whether he was also the agent of the insurance companies, although the last quotation seems to indicate that he was. Nor does it appear whether the plaintiff "consented and ratified" before or after the fire. In this respect the case differs from the *Finley* case in which it does appear that the plaintiff knew nothing of what the agent did until after the fire. In the *Arnfeld* case, however, the plaintiff relied on the fact that the five days' period had not elapsed since notice had been given the agent, rather than on the fact that he did not know that notice had been given. Finally the opinion, which incidentally does not cite a single case, does not even disclose to whom the notice of cancellation was to be given under the policy. In any event, *the case is distinguishable from our case, since Pagliero in our case neither "consented" nor "ratified"*. The Supreme Court of Pennsylvania itself distinguished it on that ground in *Scheel v. German American Insurance Company*

(1910), 228 Pa. 44, 76 Atl. 507, a case to which further reference will be made.

The case of *Larsen v. Thuringia American Ins. Co.*, 208 Ill. 166, 70 N. E. 31, is the next case relied upon by the District Court in *Finley v. New Brunswick Fire Ins. Co.* Decided in 1904, that case is again distinguishable from our case on its facts. *The plaintiff expressly ratified the cancellation* and testified himself that he had told the agent after the fire that "it did not make any difference to him, just so he got his \$2,500 of insurance". (208 Ill. at 168.) The facts disclose that the agent met the insured after the fire, explained to him what he had done, and requested the first policy in exchange for the second one, "to which appellant assented and which was done". (208 Ill. at 169.) The change of heart of the assured is not explained; nor does it interest us. It is enough to point out that in our case Pagliero never ratified Otis & Browne's agreement that Merchants' policy be cancelled.

The case of *White v. Insurance Company of New York* (1899), 93 Fed. 161, is the third case relied upon by the District Court in *Finley v. New Brunswick Fire Ins. Co.* It is distinguishable from our case on the ground that *the broker was actually authorized to keep the plaintiff insured up to a certain amount and "from time to time to substitute insurance for that originally taken out"*. (Italics supplied.) (93 Fed. at 163.) On the witness stand the plaintiff in the *White* case expressly disclaimed having ratified the taking of additional insurance by his broker in excess

of the authorized amount, and the Court stated that there was abundant evidence that he intended to adopt both the cancellation of the first policy and the procurement of the second policy. It may also be mentioned that the plaintiff was over-insured.

The case of *Strauss v. Dubuque Fire & Marine Insurance Company*, 132 Cal. App. 283, 22 P. (2d) 582, is another case upon which both the trial Court and Merchants seem to have placed considerable reliance. That case is analogous to ours only in the sense that it involves an action by a policy holder against an insurance company. The grounds of decision, however, have nothing whatever to do with our case. The plaintiffs were denied recovery (a) because they were not the owners of the property described in the policy, and (b) on account of material misrepresentation in obtaining the policy and false statements in the proofs of loss. The Court also held that another policy was substituted for and accepted by the plaintiffs in lieu of that of the defendant. Nothing is said, however, in the opinion as to how the "substitution" took place, except that it took place *by consent of the parties before the fire*. It does not appear whether a broker or agent was at all involved in the transaction and, if one was involved, what was the extent of his authority. The Court seems to have regarded the whole question of "substitution" as not being sufficiently important, in view of the other grounds of decision, to warrant a statement of the evidence bearing upon it and simply stated that the finding of "substitution" was supported by the evidence. Under the circumstances, the

case can be helpful to neither side in the present action.

It may finally be noted that neither of the two cases cited in the *Strauss* case in connection with the question of substitution supports defendant's position in the present case. The case of *Stevenson v. Sun Insurance Office*, 17 Cal. App. 280, 119 Pac. 529, involves only one insurance policy and accordingly has nothing whatever to do with our present problem. The question involved was that of the extent of a broker's authority. The plaintiff's contention was that the broker was his agent for the purpose only of placing certain insurance and that he was not authorized to cancel any policy. The Court held, however, that, although the general rule as to a broker's authority is what the plaintiff contended it to be, *authority to cancel had in fact been conferred upon the broker*. In *New Zealand Insurance Company v. Larson Lumber Company*, 13 F. (2d) 374, the broker, who incidentally was also the agent for both the first and the second company, *had actual authority from the insured to accept and act upon a notice of cancellation*.

It is clear, therefore, that the cases relied upon by the trial judge (see p. 17, printed record) do not announce a separate doctrine of substitution under which the procurement of one policy automatically terminates another. Nor have we found any other cases that do. There are, however, other cases that support our position.

In Royal Exchange Assurance of London v. Luttrell, 99 Colo. 492, 63 P. (2d) 1240, decided in 1936 by the Supreme Court of Colorado, the plaintiff recovered upon the first policy as against the contention that, by bringing another action upon the second policy, he had ratified his broker's attempt to cancel the first one. The broker, just as in our case, had the authority only to procure, which the Court held not to include the authority to accept a notice of cancellation or otherwise agree to a cancellation of the policy. The Court added that in any event "ratification after the fire would have been ineffectual because the moment the fire loss occurred defendant's liability became absolutely fixed." (63 P. (2d) at 1243.)

In Wilson v. National Ben Franklin Fire Insurance Company (1924) (Mo. App), 246 S. W. 338, the insured recovered on the first policy, notwithstanding the fact that the agent who purported to have cancelled it and replaced it with another policy was also the agent for both insurance companies. The Court based its decision on the grounds that, since the assured had no notice of the acts of the agent until after the fire, the cancellation clause had not been complied with and the policy was accordingly still in effect. The Court further held that the assured had not lost his right of action against the first company by bringing suit against the second company. Since the policy was in force, the defendant's liability attached at the time of the fire and nothing that was done thereafter could invalidate the rights of the assured. The Court finally stated that nothing that

was done thereafter could operate by way of estoppel, since it did not cause the defendant to change its position in any way.

In *Peterson v. Hartford Fire Insurance Company*, (1903), 111 Ill. App. 466 (reversed on other grounds in 209 Ill. 112, 70 N.E. 757), the Court allowed recovery against the first company in the standard situation in which the insured learned only after the fire of the purported cancellation and of the procurement of a new policy. In answering a contention of the first insurance company, the Court significantly stated that it was immaterial, so far as that company was concerned, whether the second policy was valid or not.

Even as early as 1904 it was held in a Federal Court in a situation such as that presented in our case, that the assured could recover upon the first policy, since the cancellation clause had not been complied with. The broker in that case, just as Otis & Browne in our case, was not authorized to consent to the cancellation of the policy. See *Phoenix Insurance Company v. Kerr*, 129 Fed. 723.

A similar result was reached in *Baker v. North River Insurance Company* (1923), 112 Kan. 530, 212 Pac. 118. The Court said:

“Nothing that plaintiff did . . . in an attempt to collect the loss from the American Insurance Company (the second company) estops him from claiming under this policy, for the reason that nothing done by him in that respect altered the

position of the defendant, or furnished any ground for estoppel." 212 Pac. at p. 120.

The Court added that the rights and liabilities of the plaintiff and the defendant had become fixed when the loss occurred and that nothing that was done thereafter could alter that fact.

A similar result was reached in *Scheel v. German-American Insurance Company*, 228 Pa. 44, 76 Atl. 507, the case in which, in 1910, the Supreme Court of Pennsylvania distinguished the *Arnfeld* case, cited supra. The plaintiff was allowed to recover from the first company notwithstanding the fact that he had previously collected from the second company.

A similar result was reached in *Hendricks v. Continental Insurance Company of City of New York*, (1936), 121 Pa. Super. 393, 183 Atl. 363. The insured recovered against the first company, notwithstanding the fact that the second company had previously paid him under its policy. The Court held that the cancellation of a policy could be effected only through strict compliance with the cancellation clause in that policy. The Court stated:

"It matters not that the Fire Association of Philadelphia (the second company) admitted liability. That was not detrimental to the appellant nor could it prejudice the plaintiff." 183 Atl. at 366.

Although there are no California cases precisely in point, there are numerous cases in California holding that the cancellation clause in a policy of insurance

must be strictly complied with, before the insurance company may claim that the policy is cancelled. *Quong Tue Sing v. Anglo-Nevada Assur. Corp.*, 86 Cal. 566, 25 Pac. 58; *Lauman v. Springfield Fire etc. Ins. Co.*, 184 Cal. 650, 195 Pac. 50; *Tarleton v. DeVeuve* (C. C. A. 9th), 113 Fed. (2d) 290. Having failed to comply with the cancellation clause in its policy Merchants should now be reminded by the Court that the purpose of insurance is to insure and that the very contingency occurred in which it promised to protect Pagliero from loss.

CONCLUSION.

Since the cancellation clause was not complied with and Pagliero neither agreed to a cancellation of the policy, nor authorized Otis & Browne to agree to such cancellation, nor ratified any agreement cancelling it, the judgment should be reversed.

Dated, San Francisco, California,
March 20, 1948.

Respectfully submitted,

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No. 11,831

IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, co-partners
doing business under the fictitious firm
name and style of Technical Porcelain
& Chinaware Company,

Appellants,

vs.

MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK (a corporation),

Appellee.

BRIEF FOR APPELLEE.

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Subject Index

| | Page |
|--|------|
| As to jurisdiction | 1 |
| Statement of the case | 3 |
| Argument of case | 4 |
| Summary | 4 |
| On the question of the authority of the broker | 5 |
| Authorities cited by appellants | 16 |
| On the question of ratification | 24 |
| As to appellants' citations on ratification | 41 |

Table of Authorities Cited

| Cases | Pages |
|---|----------------|
| A. Davis & Son v. Russian Transport Ins., 169 N.Y.S. 960, 182 App. Div. 668 | 45 |
| Baker v. North River, 212 Pac. 118, 112 Kans. 530..... | 42 |
| Cronewett v. Iowa Underwriters, 186 Pac. 824, 44 Cal. App. 571 | 19 |
| Emery v. Pacific Employers, 67 Pac. (2d) 1047, 8 Cal. (2d) 663 | 16 |
| Farrar v. Western Assur. Co., 159 Pac. 609, 30 Cal. App. 489 | 10, 20, 26, 34 |
| Finley v. New Brunswick Fire Insurance Co., 193 Fed. 195 | 26 |
| Finley v. Western Empire Insurance Co., 125 Pac. 1012, 69 Wash. 673 | 30 |
| Glickman v. New York Life, 107 Pac. (2d) 252, 16 Cal. (2d) 626 | 32, 33 |
| Hendricks v. Continental Insurance Company, 121 Penn. Superior 393, 183 Atl. 363 | 43 |
| Hooker v. American Indemnity, 54 Pac. (2d) 1128, 12 Cal. App. (2d) 116 | 19 |
| Kavanaugh v. Franklin Fire, 197 Pac. 99, 185 Cal. 307.... | 32 |
| Larson v. Thuringia American Ins. Co., 208 Ill. 166, 70 N. E. 31 | 37 |
| Lauman v. Conecordia Fire Ins. Co., 195 Pac. 951, 50 Cal. App. 609 | 16 |
| Lauman v. Springfield Fire & Marine, 195 Pac. 50, 184 Cal. 650 | 17 |
| National Fire v. Oliver, 204 S. W. 367 (Texas) | 41 |
| Peterson v. Hartford Fire, 118 Ill. App. 466, 70 N. E. 757 | 42 |
| Phoenix v. Kerr, 129 Fed. 723 | 42 |

TABLE OF AUTHORITIES CITED

iii

| | Pages |
|--|----------------|
| Quong Tue Sing v. Anglo Nevada Assurance Company, 25 Pac. 58, 86 Cal. 566 | 17 |
| Royal Exchange v. Luttrell, 63 Pac. (2d) 1240, 99 Col. 492 | 41 |
| Stevenson v. Sun Ins. Office, 119 Pac. 529, 17 Cal. App. 280 | 14, 20, 34, 37 |
| Strauss v. Dubuque Fire and Marine, 22 Pac. (2d) 583, 132 Cal. App. 283 | 34 |
| Tarleton v. DeVeuve, 113 Fed. (2d) 290 | 19 |
| Walsh v. Tadlock, 104 Fed. (2d) 131 | 39 |
| White v. German Alliance Insurance Company, 103 Fed. 260 | 44 |
| White v. Insurance Company of New York, 93 Fed. 161.... | 43 |
| Wilson v. National Ben Franklin, 246 S. W. 338..... | 42 |

Statutes

Civil Code:

| | |
|---|----|
| Section 2315 | 22 |
| Section 2317 | 22 |
| Section 2330 | 23 |
| Section 2334 | 23 |
| 28 U.S.C.A., Section 41 | 2 |
| 28 U.S.C.A., Sections 71, 72 and 81 | 2 |
| 28 U.S.C.A., Section 225 | 2 |
| 28 U.S.C.A., Section 345 | 2 |

Texts

| | |
|--|----|
| 5 Cooley's Briefs on Insurance, 4595, 4596 | 10 |
|--|----|

No. 11,831

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For the Ninth Circuit

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
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Appellants,

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MERCHANTS FIRE ASSURANCE CORPORA-
TION OF NEW YORK (a corporation),

Appellee.

BRIEF FOR APPELLEE.

AS TO JURISDICTION.

As stated in appellants' brief, page 2, this action was originally brought on the appellants' complaint filed in the Superior Court of Contra Costa County, California, for a sum in excess of \$3,000.00, on a claim against the defendant insurance company as a foreign corporation. The action was transferred to the Federal Court by petition for removal on the grounds of diversity of citizenship, the plaintiff being a resident of the State of California and the defendant corpo-

ration a resident of the State of New York. (Transcript pages 2 to 7.)

Removal proceedings to the United States District Court in and for the Southern Division of the Northern District of California were taken pursuant to Title 28, U.S.C.A. Sections 71, 72 and 81. Thereunder, any such action may be removed to the Federal Court if it is one as to which the United States District Court would have original jurisdiction. Under the provisions of Title 28, U.S.C.A. Section 41, the District Courts are accorded original jurisdiction in matters of controversy where the value or sum involved exceeds \$3,000.00 and is between citizens of different states.

The final decision or judgment rendered by the United States District Court in said matter (Transcript of Record, pages 29, 30), is subject to review by the United States Circuit Court of Appeals pursuant to Title 28, U.S.C.A. Section 225, except in instances where direct review may be had by the Supreme Court of the United States under Section 345, and which refers to situations where the United States is a party complainant, where the United States as a party has been rendered an adverse decision, where the constitutionality of State Statutes is involved, or with matters relating to the Interstate Commerce Commission.

STATEMENT OF THE CASE.

The statement of the case as set forth by appellants is substantially correct, with the exception that after the loss the defendant did not deny liability solely on the ground that its policy had been cancelled, but denied liability for various reasons which included the statement that liability under its policy had been terminated by substitution by another policy and because of the insured having ratified the acts and conduct of his broker. As will hereinafter appear, also, Otis & Browne as brokers for the plaintiffs, and appellants in this case, obtained the new policy, that is, the one with the Home Fire and Marine Insurance Company, solely for the purposes of replacing the policy of the Merchants, and which policy appellants accepted and under which they obtained payment. Said brokers during all the times mentioned were handling appellants' entire insurance portfolio.

There are essentially two questions involved: first, with respect to the extent of the authority of Otis & Browne as insurance brokers for plaintiffs and appellants, and, secondly, whether or not there was ratification by plaintiffs and appellants of the acts and conduct of their brokers so as to terminate liability under the policy issued by appellee.

ARGUMENT OF CASE.**SUMMARY.**

Otis & Browne, in this instance, were general insurance brokers for the appellants, exercising a larger authority and occupying a different capacity from a broker obtained merely for the purpose of issuing policies of insurance and whose agency would be terminated upon the completion of that event. This conclusion is primarily based upon the acts of the brokers in writing special forms of coverage for the appellants and having been in charge of the insureds' entire insurance portfolio.

Ratification of the brokers' acts in substituting policies occurred in this instance when the insureds, having been informed that said brokers had advised the Merchants Fire Assurance Corporation prior to the loss to close their file as their policy had been replaced, and having been informed by said brokers that they had in lieu thereof obtained another policy with another company in the same amount and on the same conditions, in fact accepted said new policy, made claim thereon, collected thereunder, and as to which liability was conceded to them by said new company. It was and is the position of the appellee that if the insureds accepted the benefits of the brokers' acts on their behalf in that respect, they must likewise adopt the brokers' purposes and what might be called the detriment that might result to them therefrom in having in effect terminated the liability under the Merchants' policy.

While the appellants' brief is divided into numerous subdivisions, the sum and substance of the argu-

ment presented is that as a policy of insurance only has one cancellation clause, that unless the provisions thereof are carried out there can be no termination of liability by the insurance company. We feel that argument on such a question is entirely beside the point and outside the issues of this case. We consider, furthermore, that cases dealing solely with the cancellation clause of the policy have no significant bearing upon the decision of the questions that are presented in this matter. It is not contended by the appellee, nor has it ever been contended, that it sent out a notice in conformance with the cancellation clause of the standard policy. It is, on the other hand, our position that a termination of the liability under the policy was effected prior to the loss by mutual agreement, and that thereby in effect the policy was cancelled. The use, therefore, of the word "cancelled" is to a certain extent misleading. It is and has been the further position of the Merchants Fire Assurance Corporation that regardless of any question of the extent of the brokers' authority there was in legal effect a ratification by the claimants of the substitution of policies, the acceptance of the one carrying with it the termination of liability under the other.

ON THE QUESTION OF THE AUTHORITY OF THE BROKER.

The facts and the evidence in support of this question are comparatively brief. In the stipulation of facts it is set forth that at all times from February 6, 1945, to July 23, 1946, which included the time of the fire, and thereafter, Otis & Browne, Inc., were act-

ing as insurance brokers for the plaintiffs. (Transcript of the Record, page 14, paragraph 3.) One of the underwriters of the Merchants Fire Assurance Corporation, Mr. Ritch, testified that about February 6, 1945, and over a year before the fire, Mr. Browne of Otis & Browne visited the office of the appellee with a letter signed by one of the appellants instructing the Merchants to recognize Otis & Browne as their brokers. (Transcript of Record, page 48, lines 4 to 15, page 49, lines 21 to 30.)

While this was denied by the broker, we submit that in such an instance where the policy had been originally issued by a different broker, it was quite logical and conceivable that the insureds would have supplied the new broker with some letter of authorization. Testimony of this witness is further confirmed by the fact that he had at the time made a notation on the company's daily report, which is its record of the policy that had previously been issued. Regardless of whether or not there was a conflict in the evidence as to appellants having written a letter as to Otis & Browne acting as brokers for the appellants, there is, nevertheless, no conflict whatever that Mr. Browne notified appellee as well as all of the other companies, that they had taken over as brokers for the appellants. (Transcript of Record, page 69, lines 18 to 21.)

On the same occasion, Witness Ritch testified that Otis & Browne presented two endorsements to them that said brokers had prepared to be attached to the policy of insurance. (Transcript of Record, page 50,

lines 1 to 27.) There is no dispute in the record with regard to the fact that the brokers prepared the endorsement appearing on the policy (Plaintiffs' Exhibit No. 1) and we direct the Court's attention to the fact that this form is in considerable detail and consists of four pages of closely typewritten matter. It indicates the exercise of a considerable discretion and general authority on the part of these brokers acting for the appellants in changing the form of insurance, revising various paragraphs and conditions and inserting special clauses, which is entirely inconsistent with the mere authority of a broker employed to obtain the issuance of a policy of insurance for an insured. As a matter of fact, the preparation and handling of this endorsement by the brokers shows that they had full and complete charge of the appellants' insurance business, which fact was fully supported by the testimony of their witness, as follows:

“(Testimony of Edward Rambo Browne.)

Cross-Examination.

By Mr. Taylor.

Q. Mr. Browne, you say that you took over the representation as an insurance broker of the plaintiffs in this case some time in December of 1944?

A. That is approximately correct.

Q. And as the questions have been brought out by Mr. Hauerken, prior to that time as to this particular policy a different broker had acted on it, isn't that so?

A. That is true.

Q. And you were substituted in the place of that broker who had issued the policy and handled the plaintiffs' insurance, is that correct?

A. Our firm was substituted.

Q. And you handled from and after that time their entire insurance portfolio, did you not?

A. That is true.

Q. It was not an appointment designating you for the issuance or the obtaining of any single policy, is that not so?

A. That is true."

(Transcript of Record, page 68, lines 1 to 22.)

While it is true that a broker employed merely to obtain or write a policy of insurance is not thereby rendered the insured's agent to accept cancellation notice, the rule is quite the contrary where his employment is more extensive, such as where the broker takes care of all the insured's insurance business.

"The broad rule must, however, be modified if the agency is a general one, and not merely a special agency for that particular policy. *A notice canceling a policy given to a broker employed generally to look after all of the policy holders' insurance business, and who has exercised such employment continuously for a considerable period, is sufficient.* This is the principle underlying the leading case of Stone v. Franklin Ins. Co., 105 N. Y. 543, 12 N. E. 45, and it has been approved and followed in numerous well-considered cases.

Reference may be made to White v. Insurance Co. of New York (C.C.) 93 Fed. 161; Parker & Young Mfg. Co. v. Exchange Ins. Co., 166 Mass.

484, 44 N. E. 614; Faulkner v. Manchester Fire Assur. Co., 171 Mass. 349, 50 N. E. 529; Buick v. Mechanics' Ins. Co., 103 Mich. 75, 61 N. W. 337; Kooistra v. Rockford Ins. Co., 122 Mich. 626, 81 N. W. 568; Edward v. Home Ins. Co., 100 Mo. App. 695, 73 S. W. 881; Standard Oil Co. v. Triumph Ins. Co., 64 N. Y. 85; Karelson v. Sun Fire Office, 122 N. Y. 545, 25 N. E. 921, affirming 48 Hun. 621, 1 N. Y. Supp. 387; Johnson v. North British & Mercantile Ins. Co., 66 Ohio St. 6, 63 N. E. 610; John R. Davis Lumber Co. v. Hartford Fire Ins. Co., 95 Wis. 226, 70 N. W. 84, 37 L. R. A. 131.

In another leading case (*Hartford Fire Ins. Co. v. Reynolds*, 36 Mich. 502) the rule thus laid down was said to apply even where the insurance agent acts as broker for the insured, and especially where he exercises his own discretion in selecting the companies among which the risk is to be distributed (*Dibble v. Northern Assur. Co.*, 70 Mich. 1, 37 N. W. 704, 14 Am. St. Rep. 470). So, where the insured employed an insurance agent to keep certain property continually insured for a certain amount, part of the insurance being taken in companies represented by the agent, and part through other companies (*Schauer v. Queen Ins. Co. of America*, 88 Wis. 561, 60 N. W. 994), such agent must be regarded as a broker, and authorized to receive for the insured notices of cancellation.

But if the agent agrees with insured to look after the business and keep up the insurance, the insured having no choice of companies, the agent has authority to accept for the assured, or to waive the five days' notice of cancellation, pro-

vided for in the policy, and obtain a new policy from another company.

Allemania Fire Ins. Co. v. Zweng, 127 Ark. 141, 191 S.W. 903; Farrar v. Western Assur. Co., 159 P. 609, 30 Cal. App. 489, application for rehearing in Supreme Court denied 159 P. 611, 30 Cal. App. 489; National Union Fire Ins. Co. v. Macon Hardwood Lumber Co., 24 G.A. App. 726, 102 S.E. 180; Aetna Ins. Co. v. Renno, 96 Miss. 172, 50 So. 563; Orkin v. Standard Fire Ins. Co., 99 N.J. Law, 114, 122 A. 823; Dalton v. Norwich Union Fire Ins. Soc. (Tex. Com. App.) 213 S.W. 230, Reversing (Civ. App.) 175 S.W. 459; Hollywood Lumber & Coal Co. v. Dubuque Fire & Marine Ins. Co. (W.Va.) 92 S.E. 858."

Cooley's Briefs on Insurance, Vol. 5, 4595, 4596.

In the case of *Farrar v. Western Assur. Co.*, 159 Pac. 609, 30 Cal. App. 489, it appeared that the owner of furniture had authorized a broker to obtain insurance in the amount of \$1,000.00 on said property. She had \$500.00 insurance through another party. Each year when the policy would expire, the broker would renew it and the assured would pay the premium. On one occasion a small fire loss occurred and the adjuster and the broker attended to the adjustment satisfactorily, and the assured then told him to take care of her insurance and to keep her covered in a good company in the amount of \$1,000.00. The policy in question was with the St. Paul Fire and Marine Insurance Company, and said company notified the broker that it wished to cancel its policy and gave him the usual five day cancellation notice. The

broker was unable to contact the assured and thereupon obtained a policy in a similar amount or made an agreement for such insurance with the defendant, Western Assurance Company. A few days thereafter, loss occurred without the policy having been issued. The Court held that there was an oral agreement for insurance, and on the question of the broker's authority to place such new insurance for the insured, the Court stated as follows:

"We think the defendant is liable. Perhaps when Coleman placed the first insurance for Mrs. Plier he was merely an insurance solicitor, whose authority was quite limited, but later, as we have seen, she extended his authority by telling him 'to take care of her insurance and to see that she was covered to the amount of \$1,000.' At another place in the record she is shown to have testified as follows:

'A. About the Western Assurance, I never told him what company to insure me in. I just said, Insure me for \$1,000, and that was all. As long as it was covered, that is all I cared.

Q. As long as it was covered?

A. Yes, sir.

Q. It says, "I looked upon him as a solicitor only."

A. I don't know about solicitor—I only told him to insure me and keep me insured.

Q. To keep you insured?

A. To keep me covered—that is all I cared—as long as I was in a good company.'

Coleman's testimony we think tends to corroborate the testimony of Mrs. Plier; but we are satisfied that the direction by Mr. Plier to Cole-

man just referred to made him more than a mere soliciting insurance agent, and constituted him, as found by the court, her general agent to keep her insured to the extent of \$1,000 in respect to the property here involved. Being her general agent for this purpose, we think he was authorized, as an incident of his employment, to accept and to act upon a notice of cancellation. Stevenson v. Sun Ins. Office, 17 Cal. App. 280, 119 Pac. 529.

'A general agent with power to insure property and to keep it insured may accept notice of cancellation and procure substituted insurance or renewal of insurance in another company.' 22 Cyc. 1447; Aetna Ins. Co. v. Renno, 96 Miss. 172, 50 South, 546; Phoenix Ins. Co. v. State, 76 Ark. 180, 88 S.W. 917, 6 Ann. Cas. 440; Schauer v. Queen's Ins. Co., 88 Wis. 561, 60 N. W. 994; Todd v. German-Am. Ins. Co., 2 Ga. App. 789, 59 S.E. 94.

But even if Coleman were not the general agent for the assured, still the finding of the court as to his authority would have to be sustained on the theory that his action in procuring the policy in the defendant was ratified by his principal. In filing her claim of loss and demanding payment, she ratified the action of her agent. The authorities seem to hold that a ratification, though made subsequent to a loss, is valid."

Thus it is that while other jurisdictions may adopt different rules, California has recognized that a broker handling an insured's business is not limited

in his authority to that of a broker employed solely to procure insurance.

The reason for this rule is rather obvious. There are many instances where one asks a broker to obtain policies of various kinds, but under such conditions it would be illogical to permit such a one to act on other matters without specific instructions—especially where it resulted in an alteration of the insured's position, such as the taking away from him of insurance protection. On the other hand, where the broker has a continuing employment and is in charge of the insured's insurance business, he is the proper one to modify forms, enlarge or decrease insurance portfolios and to generally select and change the companies with whom policies are carried.

By this decision also California has adopted a different rule from some states with regard to ratification after loss.

A reading of this decision discloses that apparently the insured obtained some settlement or payment from the St. Paul Fire and Marine, the company that carried the original policy, and the Appellate Court of California expressed some curiosity as to the basis that the insured there might have made claim from said insurance company, and which company occupies a similar capacity to the Merchants in this instance. The particular question, however, not being one before the Court, was not probed further.

Considerable discussion and comment has occurred with regard to the failure to cancel the policy in ac-

cordance with the cancellation clause and inferring that unless those steps and that procedure were followed out there could be no termination of the Merchants' liability by other means. This contention is, of course, conclusively refuted in *Stevenson v. Sun Ins. Office*, 119 Pac. 529, 17 Cal. App. 280, in which rehearing was denied by the Supreme Court of this State. There the insured had ordered \$30,000 of insurance that was obtained by the broker and subsequently requested that it be reduced to \$25,000. The broker thereupon went to the defendant insurance company and informed them that the insured had ordered their policy cancelled. Before further action could be taken, fire destroyed the property that evening. The assured contended that the broker was his agent for the purpose of negotiating and placing insurance, but was not his agent for the purposes of cancellation. With this contention the Court disagreed and it was held:

"There is no merit in the contention discussed and urged by plaintiff that the contract of insurance in the case at bar cannot be considered as canceled merely because the policy in controversy was not formally and physically surrendered into the possession of the defendant prior to the fire. A contract of insurance must be governed and interpreted by the same rules which ordinarily apply to other contracts, and it will be enforced only according to the manifest intention of the parties. It is a self-evident proposition that a contract of insurance may be as readily rescinded, as it was made, by the mutual agreement of the parties or their authorized representatives; and,

while the surrender of a policy of insurance by the insured and its acceptance by the insurer is usually *prima facie* evidence of cancellation, yet a formal physical surrender is not absolutely necessary to a rescission and cancellation of the contract. The formal surrender and acceptance of the policy is at best a piece of evidence tending to show a cancellation, and, if the fact of rescission is established (as we think it was in this case) by the mutual agreement of the parties, the rescission is as complete and effectual as if the policy had been actually indorsed ‘canceled’, and surrendered into the possession of the defendant.”

The situation in this case is quite different from the circumstances contended for by appellants with regard to the authority of a broker employed solely to procure insurance. The very fact that he is employed solely to procure insurance indicates a qualified and restricted agency. On the other hand, here we do not have any qualifications to the broker’s authority or his agency. He was the general insurance broker for the appellants, who quite apparently instructed him to contact all the insurance companies and so inform them, with no information being conveyed to them, nor apparently any instructions having been given, that the brokers were to be considered as having any limited authority. The undisputed facts are, as established by the testimony of the appellants’ own witness, that the broker had entire and complete charge of the appellants’ insurance portfolio, and it would seem, therefore, that it was fully within the

scope of their authority to adjust lines, take out new policies, replace and substitute other policies, and generally to keep the insureds' program in force and effect for appellants. Furthermore, as we have heretofore indicated, the very fact that these brokers had prepared extensive and involved endorsements shows a supervision and authority to handle matters for the appellants other than the mere procurement of policies.

AUTHORITIES CITED BY APPELLANTS.

An examination of the cases cited by appellants will show that they are all distinguishable on the facts or for other reasons. *Lauman v. Concordia Fire Ins. Co.*, 195 Pac. 951, 50 Cal. App. 609, involved a situation where a cancellation notice was given by the insurer to a broker, and the Court held that there was merely an employment to procure a policy which ended when that policy had been obtained and delivered.

Appellants then refer to other California decisions as holding to the same effect. Among these is *Emery v. Pacific Employers*, 67 Pac. (2d) 1047, 8 Cal. (2d) 663, which was a suit on an automobile liability policy with the question arising as to whether various other policies of the insured had been cancelled contrary to the insured's specific representations. On this question, the Court merely said that an agent to procure insurance is not an agent for cancellation and a notice to him is not notice to the insured. Even there, however, the Court felt that the agency might be such as to bind the insured, for it was said:

"In the instant case it would seem that upon the testimony of Bronis the jury might have found that Strother & Strother were acting as agents for Bronis for cancellation as well as procuring of insurance. Bronis testified that Strother & Strother would be better able to answer a question as to whether cancellation notices had been received on his policies than he himself would; that if he received anything he turned it over to Strother; that he had nothing to do with the insurance, and that he had implicit faith and confidence in Strother. It also appeared that Strother & Strother carried on correspondence with the insurance companies upon certain of the policies after their issue."

In *Quong Tue Sing v. Anglo Nevada Assurance Company*, 25 Pac. 58, 86 Cal. 566, the insurer's local agent contacted the broker who had obtained the policy relative to cancelling same, and the broker then went to the insured and informed him that the policy had been cancelled and offered a policy in a lesser sum. A partial tender of refund of premium was made. The assured, however, refused to accept same and the Court held that the broker was not the insured's agent for the purpose.

Lauman v. Springfield Fire & Marine, 195 Pac. 50, 184 Cal. 650, is where the insurer and the insured agreed on July 10th that the policy was cancelled, but that the policy had a mortgage clause giving the mortgagee protection for an additional ten days within which time a fire occurred. The insurer there contended that the mortgagee had told the insured to

look after the insurance, and that thus the insured had been his agent and the mortgagee would be bound by the cancellation agreement. In this respect the Court had the following to say:

"It is held in *Farrar v. Western Insurance Co.*, 30 Cal. App. 489, 159 Pac. 609, 611 (see, also, *Edwards v. Home Insurance Co.*, 100 Mo. App. 695, 73 S.W. 881), that where a broker or agent is employed to keep the property insured, he had the authority to cancel as well as to procure insurance. But the authority to keep the property insured would not be authority to consent to a cancellation of insurance which would leave the property wholly without insurance. In this case the effect of the agreement to cancel the insurance was to leave the mortgagee without any protection, although the contract already in force entitled him to protection for ten days. However, the relationship between Luman and Dodd was not that of principal and agent. They were mortgagor and mortgagee; and their relation to the property was fixed by the mortgage and by the policy of insurance wherein it was specifically agreed that the notice of cancellation should not be effective against the mortgagee until after ten days' notice in writing to him."

We believe these decisions in California rather clearly show that in this State such an agent for the insured as was there involved, or who occupied the capacity such as Otis & Browne in this instance, and who obviously had authority to keep the property insured, would likewise have authority to cancel policies or to accept cancellation notices.

The next case referred to under this subdivision by appellants is *Hooker v. American Indemnity*, 54 Pac. (2d) 1128, 12 Cal. App. (2d) 116, which was a suit on a different form of policy, same being a liability policy for the benefit of the public. The broker, upon misunderstanding instructions from his insured, cancelled the policy, and the Court declared that generally a broker who only procures insurance has no authority to effect a cancellation. The very reference to the word "generally" indicates that in many instances and in varying circumstances the Court recognized that the broker would have such authority. It is further said that in that instance there was no evidence that the broker was a general agent for the insured instructed to handle his insurance in a general way.

Cronewett v. Iowa Underwriters, 186 Pac. 824, 44 Cal. App. 571, has no bearing whatever upon the issues before this Court. It is there contended that an agent of the mortgagee to cancel and replace policies would also bind the assured mortgagor. Disposing of the question, the Court merely commented on the fact that an agent employed to place insurance is not *thereby* rendered an agent to cancel the policy.

The final case to which appellants have referred on the matter of authority is *Tarleton v. DeVeuve*, 113 Fed. (2d) 290. The broker had obtained a policy and later when the premium was not paid he returned the policy to the insurer without the insured's knowledge. The insurer, however, did not accept the return

of the policy but demanded an earned premium for the time that it had been in force and during this period a fire occurred. The insurance company then reversed its position and contended that the policy had never been in effect, and in any event that it had been cancelled. This Court, in reviewing that case, said that under *Stevenson v. Sun* and *Farrar v. Western Assurance*, heretofore referred to, they would have held that the policy had been cancelled, but that under subsequent California decisions this result would not be permitted if the insured were thereby to be left wholly without insurance. In this respect this Court had the following to say:

"If there were no other cases from California to guide us, we might feel an obligation to sustain appellees' position as to the effect of the attempted cancellation on Mrs. McElligott's claim. However, these cases have been distinguished and the principle involved elaborated in more recent decisions from the California courts. Thus, in the case of *Lauman v. Springfield Fire, etc., Ins. Co.*, 184 Cal. 650, 652, 195 P. 50, 51, the court said: '*' * It is held in *Farrar v. Western Assur. Co.*, 30 Cal. App. 489, 159 P. 609, 611 * * *, that where a broker or agent is employed to keep the property insured, he had the authority to cancel as well as to procure insurance. But the authority to keep the property insured would not be authority to consent to a cancellation of insurance which would leave the property wholly without insurance.' In the case at bar, if there had been a cancellation, the property would have been wholly without insurance."

In the pending matter, the plaintiffs and appellants, without taking into account the policy of the Merchants, had all the insurance they had ever ordered or had requested their brokers to obtain. The rule of law in California as recognized by the foregoing decisions would, under the circumstances that exist here where the brokers had obtained a valid and new policy to replace that of the appellee, clearly deny recovery. To permit otherwise would in effect occasion a double recovery.

In other words, it appears rather clearly that as far as these insureds are concerned, they desired \$300,000.00 total insurance prior to the fire. They had never given any instructions for any additional policies, and it would appear they did not wish to assume the liability for any additional premiums. Quite obviously they felt that such insurance schedule was sufficient for their purposes. On the other hand, if they were to recover from the appellee in this instance they would recover on the total of \$315,000.00 insurance, as to which additional \$15,000.00 they would have had no knowledge prior to the loss in question. Upon subsequently ascertaining that the brokers had obtained insurance with the Home Fire and Marine Insurance Company solely for the purpose of replacing appellee's policy, and as to which they had informed the Merchants to close their file as their policy had been replaced, they would ask this Court to permit them to accept and take advantage of that policy, but to repudiate and deny the terms under which and the purposes for which their

brokers had obtained it. If it were the fact that said company had repudiated its policy, or that the insureds would suffer detriment whereby the brokers had altered their insurance schedule, possibly a different result would have been called for.

On the matter of ostensible agency it is provided by the Civil Code of California:

“Authority Limited to Appointment—An agent has such authority as the principal, actually or ostensibly, confers upon him.”

Civil Code, Sec. 2315.

“Ostensible Authority—Ostensible authority is such as a principal, intentionally or by want of ordinary care, causes or allows a third person to believe the agent to possess.”

Civil Code, Sec. 2317.

The defendant in this instance would have had no reason to communicate with Otis & Browne except for plaintiffs' having intentionally sent them to defendant with evidence of their authority to write endorsements for plaintiffs and as to their supervision of plaintiffs' insurance. Defendant was fully justified in thereafter giving notice to terminate liability to the brokers and in relying on their advice that a substitution of policies had been effected. Under these facts, there is a clear estoppel against plaintiffs' repudiating or denying the authority of their agents, the effect of their acts and conduct or of the effect of defendant having relied thereon.

“An agent represents his principal for all purposes within the scope of his actual or ostensible

authority, and all the rights and liabilities which would accrue to the agent from transactions within such limit, if they had been entered into on his own account, accrue to the principal."

Civil Code, Sec. 2330.

It is quite apparent that if it had not been for the brokers' letter to the Merchants, the latter would have sent out a formal cancellation notice to the insured.

"A principal is bound by acts of his agent, under a merely ostensible authority, to those persons only who have in good faith, and without want of ordinary care, incurred a liability or parted with value, upon the faith thereof."

Civil Code, Sec. 2334.

Appellants complain of the fact that ostensible agency is not applicable to this case for the reason that such ostensible authority is solely determined by the conduct of the principal and not that of the agent. But in this instance, it is our contention that it was the conduct of the insureds which directly caused and induced the insurance company to contact the brokers and to rely on them.

Objection is further raised by the appellants in regard to the admission in evidence of defendant's exhibits B and C. These letters were perfectly proper, not only for the reason that they corroborated the testimony of the witness Browne as well as the agreed statement of facts, but likewise in view of the extent of the brokers' authority as heretofore established, they were binding on the insureds, and in establishing that after having been informed that their policy

had been replaced and that they could close their file, the Merchants Fire Assurance Corporation had relied upon them to the extent of taking no further action. It is quite obvious from the nature of the communications that if they had not been received formal cancellation notice would have gone out prior to the loss in question.

ON THE QUESTION OF RATIFICATION.

As appears from the Record the original exhibits B and C have been sent up to this Court from the District Court rather than having been set forth in the Transcript of the Record. (See pages 34 and 35 Transcript of Record.) It appears that about six weeks prior to the occurrence of the fire the Merchants Fire Assurance Corporation addressed appellants' brokers as follows:

“Will you kindly cancel this policy and return it to us for pro rata cancellation? The company has requested us to retire from the liability because we are no longer willing to accept this classification. If you would prefer, we can send cancellation notice direct to the assured. However, we will not do so unless you specifically instruct us.”

(Transcript of Record page 52, lines 17 to 24.)

Thereafter, and about three weeks before the fire, said company, not having had any reply from Otis & Browne, sent them a letter in the following form:

“Re: Policy No. 8604, Technical Porcelain Company.

We are following up a letter written to you on April (16) 10th asking for cancellation of this policy.

We understood that you were going to relieve us of liability as soon as possible although no definite date was set for the termination.

Will you kindly follow this up and endeavor to have our policy returned within the next ten days?"

(Transcript of Record page 55, lines 7 to 17.)

Several days thereafter this letter was returned to appellee by Otis & Browne with the notation on it, "You may close your file as this has been replaced as of April 10th, 1946. Policy is at Mechanics Bank Richmond and will require some time to secure unless you wish to send cancellation notice dated ten days prior to April 10th, 1946." Appellant raises some contention with regard to this note to the effect that it indicated to the insurance company that the brokers did not have authority to act and that the company should send cancellation notice out to the insureds. On the other hand, we believe this note indicates just the contrary. In other words, the brokers were referring to the return of the policy to the insurance company and that they could not get it for some time and that, therefore, if the insurance company wished to send out a predicated cancellation notice, it probably would have no concern about a return of the policy. The significance of this language relates solely to the statement by the insurance company that they wished their policy returned within the next ten days.

The fact is that the brokers did not feel that any further notice or advice to the insurance company was called for, for it appears in the stipulation of facts that, upon receipt of the first mentioned letter some weeks previously from the Merchants, Otis & Browne had immediately gone out and obtained a policy of fire insurance with the Home Fire and Marine in the same amount of \$15,000.00 insuring plaintiffs on the same property from that very day for a period of three years. This last mentioned company never at any time denied or questioned its liability under said coverage, and, upon claim being made by appellants, it paid them the very same sum that said appellants are claiming in this action from appellee. (Transcript of Record pages 14 and 15, paragraphs 4, 5, and 8.)

Witness Browne affirmed the fact that his reference to having "replaced" the policy of the Merchants specifically referred to the policy of the Home Fire and Marine Insurance Company. (Transcript of Record page 71, lines 10 to 22.)

In line with what is said in the case of *Farrar v. Western Assurance Company* at the bottom of page 9, the appellants, in making claim for and demanding payment under the Home Fire and Marine policy, ratified the authority and acts of the brokers in obtaining said policy, and as will appear from the case of *Finley v. New Brunswick Fire Insurance Co.*, 193 Fed. 195, appellants had the right to claim under one policy or the other and, having accepted the new policy and obtaining reimbursement thereunder, they

likewise must be held to have adopted the object and purpose for which said policy was obtained, namely to replace that of the Merchants.

In said case the defendant's agent had looked after plaintiff's insurance for some years. On August 16, 1910, defendant requested its agents to pick up their policy. Rogers & Rogers, the agents, received this request on August 20, 1910, and on the same day obtained for plaintiff a policy with the Western Empire Insurance Company in the same amount as defendant's policy and on the same property. On the next day the property was destroyed. After the fire, plaintiff accepted the Western Empire policy from Rogers, but refused to relinquish defendant's policy on being told that said company had requested that it be cancelled.

Plaintiff sued both companies and recovered from the Western Empire.

The Court said:

"The Western Empire policy was taken out by Rogers & Rogers assuming to act for plaintiff, for the purpose of replacing the policy in suit, which they had been instructed to pick up and retain, and not for the purpose of increasing the amount of insurance already on the property.

* * * On the morning of August 20th, the property was insured in the sum of \$7,500, or in one and one half times its full or sound value; the plaintiff had not applied for further insurance, and did not know that such an application had been made in his behalf. The new policy was taken out immediately upon receipt of instruc-

tions to cancel one of the existing policies, and manifestly as a substitute for the existing policy, and not as new or increased insurance. Under these circumstances the property was never insured in excess of \$7,500, and was never covered by more than three policies. And assuming for the purposes of this case that Rogers & Rogers had no authority to cancel the policy in suit, or to substitute another policy in its place, yet, when the plaintiff was informed as to what had taken place, it was incumbent on him to elect which policy he would claim under. If Rogers & Rogers acted without authority, he might disavow their acts, and claim under the three old policies which were in force at the time of the fire, or he might ratify the substitution which his agents had made in his behalf, and without authority; but manifestly he could not do both. He could not claim the benefit arising from the act of his agents in taking out a policy, and at the same time repudiate the object and purpose for which the new policy was obtained. These conclusions would seem inevitable from a mere statement of the facts, and are amply supported by the authorities.

In *Arnfeld v. Guardian Assur. Co.*, 172 Pa. 605, 34 Atl. 580, the insurance broker acted, or attempted to act, for both parties in substituting one policy for another, as was done in this case, and the trial judge was requested to instruct the jury as follows:

That 'if the jury believe from the evidence that the plaintiffs, by their agent, Charles Zug-schmidt, on the 10th day of May, 1893, took out a policy in the Queen Insurance Company

for \$2,500 upon the same property as that covered by the policy in suit, and that their purpose in so doing was not to increase their line of insurance, but to substitute the policy in the Queen in the place of the policy in suit, because the defendant had given notice on the 8th of May, 1893, to cancel the policy in suit within five days, in accordance with its terms, and the Queen Company recognized their responsibility, and paid the plaintiffs the amount covered by their policy, the moment the risk was covered in the Queen, the policy in suit was thereby cancelled, the defendant released, and the verdict should be for the defendant.'

This request was refused, and in reversing the judgment, the Supreme Court said:

'The court below being of opinion that as plaintiffs had the right to take out double insurance, and as the five days in which they were requested to have the first policy cancelled had not expired at the date of the fire, and as the policy was still in possession of the plaintiffs, without any direct return to them of, or offer to return, unearned premium, the policy was still in force, declined to give the instruction prayed for. The only question, then, is, Should this point have been affirmed? It may be conceded that there was no formal, technical cancellation of the policy issued by the defendant. It was in possession of plaintiffs. Defendant had not returned or offered to return to them the premium. But was there a substitution of the liability of a third party for that of the defendant by the consent of the plaintiffs, defendant, and the third party? Defendant's

contract was one of indemnity in a fixed amount against loss by fire on certain goods. A third party, the Queen Insurance Company, took its place, and indemnified plaintiffs against precisely the same loss, in the same amount, on the same goods, then stood by its contract, and paid the loss. This was a complete and effectual substitution of another insurer in place of defendant, and this by the consent of all parties interested; for it is not important to discuss the exact authority of an insurance broker, as Zugschmidt was, and determine to what extent he was the agent of the insured and the insurers. That is where the line should be drawn. It is undisputed he acted throughout for the plaintiffs and for both companies, and communicated with both; and all consented and ratified his acts. Nor is it controlling that there was no formal cancellation or surrender of the first policy. The plaintiffs got the policy in the Queen Company, and, what is more important, got the money upon it. The premium they had paid to the defendant, in so far as they were entitled to a return of it, is owing by the defendant, through the broker, to the Queen Company, to whom the broker, acting for plaintiffs, transferred defendant's liability. Plaintiffs ought to have surrendered after cancellation defendant's policy. What ought to have been done equity will consider as having been done.' "

The companion case of *Finley v. Western Empire Insurance Co.*, a Washington decision, 125 Pac. 1012, 69 Wash. 673, involved the suit on the policy alleged

to have been obtained in substitution of one of the others and conforms the decision above referred to. It was the contention of this insurance company that its policy had not been issued, delivered nor accepted prior to the fire, and that the assured had no notice of the broker's efforts to cancel the New Brunswick policy and obtain defendant's policy until after the fire, and the substitution therefor had not been effected. To this contention the Court stated:

"Here, Rogers & Rogers, acting as agents for respondent, secured the new policy in order to effect a substitution, so as to keep the property insured up to \$7,500, which considering the whole record, we think they were authorized to do. Their act was the act of, and their knowledge was the knowledge of, the respondent; and the time limit on the notice of cancellation, being for the benefit of the assured, was waived when they contracted for other insurance. The New Brunswick policy had no binding force after August 20th, for the reason that the agreement to take appellant's policy was in legal effect an acceptance of it."

Under the circumstances involved in the two foregoing cases, it will be observed that the assured was permitted recovery on the policy obtained in substitution of the original one and the original insurer was relieved of liability.

Here, likewise, the brokers had been looking after plaintiffs' insurance for about a year and a half before the loss occurred. Here, the insured also first obtained notice of the events as to substitution after

the fire and refused to return the original insurer's policy. Here, as there, plaintiffs claimed under both policies, but in that instance as distinct from this, the new insurer refused to concede liability.

The facts as presented by the two foregoing decisions are practically identical with those that concern us here. Appellants would endeavor to avoid the effect of these decisions by an inference that the law in California might be different by alluding to the fact that *Kavanaugh v. Franklin Fire*, 197 Pac. 99, 185 Cal. 307, and *Glickman v. New York Life*, 107 Pac. (2d) 252, 16 Cal. (2d) 626, are later decisions. The *Kavanaugh* case deals with an entirely unrelated matter. It does not hold even for the proposition for which appellants cite it, namely that provisions of contract law do not apply to insurance. The case concerns solely the question of the application of the sole and unconditional ownership clause of the California Statutory policy. As an aside the Court says that in decisions bearing upon insurer's responsibility, the policy has been treated more as a commodity than a contract and that rules have been evolved that are not applicable to ordinary contracts. Nothing, however, is said about ordinary rules of contract law not being applicable to insurance policies, but only that in addition thereto there are other principles that are applicable. The particular point there being discussed was the question of the insurance company taking an application for insurance without making specific inquiries and eliciting specific answers, and the effect

that this course of conduct would have in waiving the sole and unconditional ownership clauses.

As far as the *Glickman* case is concerned, it deals with life insurance and surrender values thereunder and comments on the fact that while ordinarily one is presumed to know the contents of his contracts, the elements of estoppel may prevent this rule from applying particularly as it relates to insurance policies. Appellants have needlessly consumed space in their brief and taken up the time of this Court in reading these citations. The *Speegle* case, referred to on page 22 of appellants' brief, revolves around alleged violations of the Cartwright Act and the subject of anti-trust combines.

It would likewise be inferred that these cases hold and that there is a principle of law that a policy of insurance is construed strongly against an insurer. That is at best an incomplete statement, the fundamental principle being that if there is ambiguity, the policy having been prepared by the insurance company, such ambiguities would be construed most strongly against the insurer. On the other hand, if there are no ambiguities in the contract, it merely remains for a Court to ascertain the meaning and intent of the terms and no occasion is called for it to be construed more strongly against the one party or the other.

It is, of course, a common thing, and one anticipated in every case involving an insurance company, for the trite remark to be made, as it is here, that a policy

of insurance is one of indemnity, that the premium was paid and that, therefore, the policy should be construed against the company. The principle that is so often overlooked is declared in the *Glickman* case cited by appellants:

“Policies of insurance create reciprocal rights and obligations, and the relationship created between the contracting parties should be characterized by the exercise of mutual good faith. Couch, Cyc. of Ins. Law, vol. 1, p. 48; see, also, *McElroy v. British American Assur. Co.*, 94 F. 990, 1000.”

By the same token, the reference to the fact as to whether the total insurance of appellants including the policy of the Merchants, was in fact less than the total values and total loss sustained by the appellants, is of no consequence except possibly to endeavor to induce sympathy. The fact remains that if the appellants had desired additional insurance they would have requested it and supplied their brokers with some orders to that effect.

As a matter of fact, we believe the holding in *Strauss v. Dubuque Fire and Marine*, 22 Pac. (2d) 583, 132 Cal. App. 283, to be entirely consistent with the decision in *Farrar v. Western Assurance Company* and *Stevenson v. Sun*. The three cases read together definitely establish the adoption of a principle of law in California recognizing the effect of the substitution of policies. In said case it appeared that the defendant originally had a policy covering the plaintiff, but that a policy in the Merchants Fire Assurance Cor-

poration was obtained in lieu of defendant's policy. The plaintiff contended that there had never been a formal cancellation, but the Court held that the policy was in effect cancelled when another policy was substituted for it.

The facts further were that the defendant Dubuque Fire and Marine Insurance Company had on March 26, 1931, written to the plaintiff's broker, one Coleman, requesting the return of their policy. She requested them not to cancel as it would make the replacement more difficult and to give her a few days. On April 1st or 2nd, 1931, she advised defendant their policy had been replaced, but refused to name the new company. The defendant then issued a cancellation notice but before it could become effective and on April 9th the property was destroyed by fire. It later appeared that the broker had not been able to replace the defendant's policy herself, but with the aid of another broker, she obtained on April 1, 1941, a policy with the Merchants Fire Assurance Corporation, by coincidence the same company that is the appellee here, for the same amount and on the same property as in defendant's policy. Following the fire, plaintiff claimed under the Merchants policy and payment was made by it. After the fire the broker told plaintiff that the Merchants policy was to replace defendant's policy, but plaintiff refused to return the policy of the Dubuque Fire & Marine.

Judgment was in favor of defendant and said judgment and the following finding was upheld by the Appellate Court of California:

"And the court finds that on the 1st day of April, 1931, and prior to the occurrence of the fire referred to in the amended complaint, the policy issued by defendants was cancelled. * * * And the court finds that prior to the time of the fire another insurance policy, to-wit: a policy of the Merchants Fire Assurance Corporation of New York, in the amount of \$3000.00 and on the same property described in the policy issued by defendants, was substituted for and accepted by the plaintiffs in lieu of the policy which had theretofore been issued by the defendants; and the policy of the defendants was cancelled. * * * The court further finds that the policy of the defendants referred to in the amended complaint was cancelled by consent of the parties prior to the time of the fire."

The Court said:

"It is next asserted that the policy issued by the defendants was never cancelled. If the plaintiffs mean that the policy was never indorsed in ink 'canceled', then their contention conforms to the facts. However, an insurance policy is in effect canceled when another policy is substituted for it. *Stevenson v. Sun Insurance Office*, 17 Cal. App. 282, 288, 119 P. 529; *New Zealand Ins. Co. v. Larson Lumber Co.* (C.C.A.), 13 F. (2d) 374. That in the instant case there was a substitution is clearly supported by the evidence. It may be claimed that there was a conflict in the evidence, but that conflict was addressed to the trier of the facts.

It is again asserted that the policy was in full force and effect at the time of the fire. As we

have just seen, in discussing the previous point that the finding of substitution must stand, it follows that the policy was not in force or effect at the time of the fire."

The facts in the above case are not set forth in the opinion but are, of course, disclosed by the record and briefs on file with the Appellate Court in said matter and upon which the foregoing comments are based. On its facts the foregoing case is considerably weaker than the pending one in that among other things, the broker Coleman was only one of several brokers handling the insured's business. There was also some question as to whether or not the insured there had requested an additional policy. Appellants endeavor to distinguish said case on the premise that substitution there took place by consent, but that was the finding or conclusion of the Court and there was no consent in the sense that the claimant conceded that question. It is also said that plaintiffs there were denied recovery because they were not the owners of the property, but that is only one of several reasons for the insured's failure to recover. Some exception is taken of the fact that in that opinion reference is made to the *Stevenson* case previously referred to, which it is said only involved the matter of a single policy.

Consistent with the holding in California are also a number of other well-considered cases among which is *Larson v. Thuringia American Ins. Co.*, 208 Ill. 166, 70 N.E. 31. This was an action where the plaintiff insured requested a broker to write \$2500 of insurance

which he placed with three companies, and upon obtaining a request by one for cancellation, he replaced it with defendant's policy. The insured knew nothing of the circumstances prior to the fire. Just as here, the plaintiff recovered on the replacement policy and, in suing on the contract that was to have been substituted, the Court denied recovery and stated as follows:

"The facts as above set forth are undisputed, and the only question remaining is as to the liability of appellee under them. The appellee contends that it is not liable upon two grounds: First, that appellee could and did ratify the acts of Bennett after being fully informed as to them; and, secondly, that, if Bennett was not the agent of appellant, but was the agent of appellee, and by its direction canceled this policy and procured other insurance in the place of it, appellant was fully and fairly informed as to the entire transaction, and he was put to his election whether he would rely upon the policy issued by appellee, or whether he would take the policy issued by the North British & Mercantile Company in lieu thereof, and that he did elect to and did receive the latter policy, and the evidence shows, and it is undisputed, that appellant received from the North British & Mercantile Company the proportion of the loss that it was agreed at the adjustment should be paid by it. Appellant's contention is that Bennett was not his agent for the purpose of canceling or consenting to the cancellation of appellee's policy, and did not represent him when he replaced the insurance covered by appellee's policy in the policy of the North British & Mercantile Company, and that, as he had no knowl-

edge of the transaction until after the fire and the loss had been incurred, it did not lie in his power then to ratify any agreement by which appellee would be released from liability that had become fixed and substitute another therefor, and that appellant received no consideration for such agreement after it was made. It is not claimed by appellant that he was at any time to have more than \$2,500 insurance upon his property. The North British & Mercantile Company at no time denied its liability, but acknowledged the same, and paid according to the adjustment. We can see no reason, and none has been pointed out, why appellant could not ratify the acts of Bennett if they were not authorized at the time they were done, if he was fully and fairly informed as to such acts, and why such ratification would not and ought not to be binding upon him. The general rule seems to be that one may ratify that which is done by another if he could have himself done the same thing in the first instance. 1 Am. & Eng. Ency. of Law (2d) Ed. 1184; Zottman v. San Francisco, 20 Cal. 96, 81 Am. Dec. 96. It is said that 'ratification as it relates to the law of agency is the express or implied adoption of the acts of another by one for whom the other assumes to be acting, but without authority; and this results as effectually to establish the duties, rights, and liability of an agent as if the acts ratified had been fully authorized in the beginning.' 1 Am. & Eng. Ency. of Law (2d. Ed.) 1181."

In the maritime case of *Walsh v. Tadlock*, 104 Fed. (2d) 131, this Court declared:

"Appellants further urge that the brokers, who were their agents, had no authority to make arrangement limiting their coverage to the extent found. But they are not in position to claim the benefits of the arrangement and at the same time deny the authority of their brokers to make it."

The foregoing is the identical principle for which we are contending in this instance.

A similar decision to those heretofore referred to by us occurred where both companies denied liability and the plaintiff sued both companies. The facts briefly were that the insured's broker had been requested by him to take his insurance and keep it up. The broker thereupon obtained a \$2500 policy with the Northern Assurance, and upon having its request to cancel, he obtained a similar policy with the National Fire intending to replace that of the Northern, and without the insured being aware of the transactions prior to the fire. The Court declared that the broker had authority to accept cancellation and that the liability of the Northern Assurance Company ceased and that of the National Fire began when the latter's policy was issued. A portion of the decision is interesting.

"By arranging with Mrs. Croley 'to take his insurance and keep it up for him', as he testified he did, appellee authorized her to do for him everything reasonably necessary to be done to keep up the insurance. The assurance company having determined to exercise the right it had to cancel the policy it had issued on the property, it was necessary, in order 'to keep up the insur-

ance', to arrange with some other company to carry the risk. Incidental to this was the cancellation of the policy issued by the assurance company, for appellant's assumption of the risk was to become effective only when the assurance company ceased to carry it. We are of the opinion, therefore, that it sufficiently appeared that Mrs. Croley had power to bind appellee by consenting to a cancellation of the policy, and that acting for him, she consented when she arranged with appellant to take over the risk. We think the testimony warranted a finding that the liability of the assurance company ceased, and the liability of appellant began, when Nisbet agreed with Mrs. Croley that appellant would take over the risk of the property. (Citing *Ferrar v. Western Assurance*, 30 C.A. 489, 159 P. 609, and *Stevenson v. Sun*, 17 C.A. 280, 119 P. 529)."

National Fire v. Oliver, 204 S.W. 367 (Texas).

AS TO APPELLANTS' CITATIONS ON RATIFICATION.

The principal case cited by the appellants on the question of ratification is *Royal Exchange v. Luttrell*, 63 Pac. (2d) 1240, 99 Col. 492. It is clearly distinguishable in that the new policy obtained by the broker was for a different premium and for a short term. The court there said that the broker had only been employed for the purpose of obtaining a policy and had no further authority. We would call attention to the fact that the decision well may have been different on these facts, for it was there said:

"Not knowing which of the two companies was liable, Luttrell, out of abundance of caution, sued

both, for the purpose of recovering, not against both, but against the one whose policy the court should decide was in force. The second was to be a substitute for the first and was to be effective as such only upon cancellation of the first."

In *Baker v. North River*, 212 Pac. 118, 112 Kans. 530, while the Court not only held that the broker there had no authority to act, the decision was in part based upon the circumstance that the new policy had been for a different amount, a different premium and included a mortgage clause, and it was said that regardless of anything else the agent would not have authority to write a new and different contract. Significantly, the company issuing this policy had denied liability.

An examination of the reports in *Wilson v. National Ben Franklin*, 246 S.W. 338, indicates that a suit had been filed by the insured on both policies, and it was quite clearly indicated by the Court that recovery would be permitted on one policy or the other, but not on both, in view of the intended substitution.

Peterson v. Hartford Fire, 118 Ill. App. 466, 70 N.E. 757, is not pertinent as it involved an attempt by a mortgagee to substitute policies for the insured and as to fraudulent acts of the insurance company's agent.

Phoenix v. Kerr, 129 Fed. 723, cited by appellants was an action where the insured had filed suit on the second policy and failed to recover. In an action thereafter on the original policy the court in effect

said that if the second policy had not gone into effect by the same token the defendant's original policy was still in force.

The *Scheel* case, referred to on pages 25 and 31 of appellants' brief, turned on the question as to the absence of knowledge by the insurance company of efforts to replace the policy prior to the loss.

Hendricks v. Continental Insurance Company, 121 Penn. Superior 393, 183 Atl. 363, and referred to on page 31 of appellants' brief, will be found to be a case where the insurer's agent was the sole party attempting the substitution of insurance and where the primary insurer, having had a \$4,000 policy, was endeavoring to substantiate that said policy had been replaced by one for \$2,000. Under the facts there, we believe most courts would have found that no replacement of policies had been effected. We see no necessity for further prolonging this brief by more detailed comment as to these various citations.

It is respectfully submitted that the decision of the District Court in this matter was in conformance with the facts and the law and especially consistent with equitable principles. It conforms with the decided weight of authority and with the principles that have been followed by the courts in California. Following the same line of authorities previously referred to in this brief are other federal decisions, such as *White v. Insurance Company of New York*, 93 Fed. 161, where the insurance company notified the broker to cancel, and, after the broker obtained another policy,

the assured collected thereon. The Court held that the old policy had thus been cancelled. This case was affirmed by the United States Circuit Court of Appeals in *White v. German Alliance Insurance Company*, 103 Fed. 260. It is to be noted also that it was there said that letters passing between the insured's broker and the insurance company are admissible as a link in the chain of proof as to the broker's authority, just as in this instance, the Court said that there was, in addition, evidence that the insured had accepted payment of the substituted policies, and to which the correspondence referred.

We believe it is in order to close this brief with reference to a case in the State of New York, where insurance decisions have long been influential generally. The broker there, had, as here, substituted policies of which the insured learned after the fire had occurred. The decision in part was as follows:

"It appears that the plaintiff retained the Insurance Underwriters and the Aetna policies, and has collected in full upon them, and is now seeking to collect also upon the policy of defendant. While it was not shown that Fred S. James & Co. had any power to cancel the Russian Transport policy and replace the insurance in other companies, nevertheless the plaintiff, having accepted the two policies with full knowledge that they were taken out in place of the Russian Transport policies, could not keep them and recover upon that insurance without ratifying the act of Fred S. James & Co. in making the substitution, and technically while it might be that the Russian Trans-

port policy was not cancelled at the time of the fire, and had never been surrendered for cancellation, nevertheless the plaintiff was bound to take their position and return the Russian Transport policy for cancellation or refuse to accept the Insurance Underwriters and Aetna policies in place thereof. The plaintiff could not ratify the act of the agents insofar as it was beneficial to it without adopting the part that was not to its advantage."

A. Davis & Son v. Russian Transport Ins., 169 N.Y.S. 960, 182 Ap. Div. 668.

Dated, San Francisco, California,
April 13, 1948.

Respectfully submitted,

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No. 11,831

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, co-partners
doing business under the fictitious firm
name and style of Technical Porcelain
& Chinaware Company,

Appellants,

vs.

MERCHANTS FIRE ASSURANCE CORPORATION
OF NEW YORK (a corporation),

Appellee.

APPELLANTS' REPLY BRIEF.

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FILE

MAY 13 1948

PAUL P. O'BRIEN

Subject Index

| | Page |
|---|------|
| The question of the scope of Otis & Browne's authority..... | 2 |
| The question of ratification | 9 |
| Conclusion | 16 |

Table of Authorities Cited

| | Pages |
|--|------------|
| A. Davis & Son v. Russian Transport & Insurance Co., 169 N.Y.S. 960 | 13, 14 |
| Arnfeld v. Guardian Assurance Company of London, 172 Pa. 605, 34 Atl. 580 | 12, 15 |
| Ferrar v. The Western Assurance Company, 30 Cal. App. 489, 159 Pac. 609 | 11, 12, 14 |
| Finley v. Western Empire Ins. Co., 69 Wash. 673, 125 Pac. 1012 | 12, 14, 15 |
| Larsen v. Thuringia American Ins. Co., 208 Ill. 166, 70 N. E. 31 | 12, 15 |
| Lauman v. Coneordia Fire Insurance Company, 50 Cal. App. 609, 195 Pac. 951 | 5, 6, 7 |
| National Fire Ins. Co. v. Oliver (Texas Civ. App.), 204 S. W. 367 | 13, 14, 15 |
| Stevenson v. Sun Insurance Office, 17 Cal. App. 280, 119 Pac. 529 | 12, 14 |
| Strauss v. Dubuque Fire & Marine Insurance Company, 132 Cal. App. 283, 22 P. (2d) 582 | 12 |
| Walsh v. Tadlock, 104 Fed. (2d) 131 | 13 |
| White v. Insurance Company of New York, 93 Fed. 161.... | 14, 15 |

No. 11,831

IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

ANTONE A. PAGLIERO, JOHN B. PAGLIERO
and ARTHUR J. PAGLIERO, co-partners
doing business under the fictitious firm
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MERCHANTS FIRE ASSURANCE CORPORATION
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Appellee.

APPELLANTS' REPLY BRIEF.

The trial Court based its decision on two or possibly three grounds: It held first that Otis & Browne were authorized to receive and act upon Merchants' request that the policy be cancelled or to otherwise agree to the cancellation of the policy; it held further that Pagliero ratified Otis & Browne's agreement that the policy be cancelled; and it finally held that there was a substitution of policies, although it is not clear whether the latter conclusion is merely a restatement

of either of the previous grounds, or whether it is a separate ground for the judgment.

Only the first two grounds are urged in the brief filed on behalf of Merchants. No reliance is apparently placed upon the so-called doctrine of substitution, except in so far as it is contended that a "substitution" resulted from acts which Otis & Browne were allegedly authorized to do or from the alleged ratification of those acts by Pagliero. With such a position we can have no quarrel. We concede that Pagliero cannot prevail in this action, if Otis & Browne were authorized to agree to a cancellation of the policy, or if Pagliero ratified that agreement. Conversely, however, it is our contention that Pagliero must prevail if Otis & Browne were not authorized to agree to a cancellation of the policy, or if Pagliero did not ratify that agreement.

THE QUESTION OF THE SCOPE OF OTIS & BROWNE'S AUTHORITY.

To support its contention that Otis & Browne were authorized to receive and act upon its request that the policy be cancelled or to otherwise agree to a cancellation, Merchants relies upon the following evidence:

(1) Upon becoming Pagliero's brokers, in the early part of 1945, Otis & Browne revised the policy which Merchants had previously issued to Pagliero and prepared several endorsements which were attached thereto. Merchants contends that the prep-

aration of those endorsements is "entirely inconsistent with the mere authority of a broker employed to obtain the issuance of a policy". (Brief for Appellee, page 7.) This is a surprising assertion to be made by an insurance company, for such a company might well be expected to know that to prepare endorsements so that a policy will fit the *particular requirements* of the assured is part of the duty of *any* broker, including a broker who does nothing but procure the policy. Accordingly, the fact that, upon becoming Pagliero's brokers, Otis & Browne procured for Pagliero what amounted to a new policy in no way tends to show that their authority extended beyond the procurement of that policy. Nor does the fact that Otis & Browne procured several other policies for Pagliero tend to show that, as to Merchants' policy or, for that matter, as to any other policy, their authority went beyond the procurement stage.

(2) Merchants further relies on the testimony of Browne to the effect that Otis & Browne handled Pagliero's "entire insurance portfolio". That testimony is found at page 68 of the printed record. On cross-examination by counsel for Merchants, Browne first confirmed the testimony that he had given on direct examination as to the circumstances under which Otis & Browne had become Pagliero's insurance brokers. He was then asked the following question, to which he gave the following answer:

"Q. And you handled from and after that time their entire insurance portfolio, did you not?"

A. That is true."

Thus, the language upon which Merchants now insists so much is not the language of the witness himself, but that of counsel for Merchants. Nowhere else in the testimony of Browne or, for that matter, nowhere else in the record, is there any evidence that supports in any way the construction now sought to be given the three words thus put in Browne's mouth. It would seem that a trap was set for the witness, who of course had far less trial experience than cross-examining counsel. His answer might later turn out to be useful, if he answered the "entire portfolio" question affirmatively. If, on the other hand, he answered it negatively, no great harm would result, for it could always be shown that both his direct and his cross-examination were really directed toward other channels.

Instead of asking Browne or Pagliero specific questions as to the extent of Otis & Browne's authority, counsel chose to limit himself to the "entire portfolio" question, without even ascertaining whether these extremely equivocal words meant the same thing to the witness as they did to him. Nothing indicates that the trial judge rested his decision on Browne's answer to that question. Since there is no other evidence in the record which can be used to sustain the decision, Merchants can hardly be blamed for repeating the words "entire portfolio" at practically every other page of its brief. It is submitted, however, that, when considered in, instead of out of, their context, they cannot be used for that purpose.

To determine the significance of that testimony it is necessary to remember that the burden of proof as to the extent of Otis & Browne's authority is upon Merchants and that an insurance *broker*, as such, is not authorized to receive and act upon a notice of cancellation or to otherwise agree to the cancellation of a policy. It was accordingly sufficient for Pagliero to show that Otis & Browne were his brokers, without in any other way qualifying their authority, for the law itself provides that a broker is not authorized, unless his authority is otherwise qualified, to do more than procure a policy. The fact that, as stated by Merchants, "here we do not have any qualifications to the broker's authority" (Brief for Appellee, page 15) means either that Otis & Browne's authority was limited to the procurement of the policy or that Merchants failed to show that their authority was greater; but, since the burden of proof was upon Merchants, it does not and cannot mean that Otis & Browne were authorized to agree to the cancellation of the policy. That a broker does not as such have the authority to agree to a cancellation of the policy is of course settled. See for example the case of *Lauman v. Concordia Fire Insurance Company*, 50 Cal. App. 609, at 616, 195 Pac. 951, in which the Court said that the brokers involved in that case were "mere brokers, and being such were without authority to accept notice of cancellation".

It is in the light of those rules that the testimony of Browne must be considered. On direct examination, he testified that he was Pagliero's *broker*. Since

his cross-examination must be taken to have referred to his testimony on direct examination, his answer to the question of whether or not Otis & Browne handled Pagliero's entire portfolio can only mean that they handled it as brokers. It is, of course, conceded that Pagliero had no other insurance broker at the time. It does not follow, however, that Pagliero had given his brokers the authority to agree to a cancellation of any of his policies. Nowhere in the testimony of Browne or of anyone else is there any evidence that, as to Pagliero's entire portfolio, or as to any part thereof, Otis & Browne were authorized to agree to the cancellation of a policy or to do anything else which might be construed as implied authority to agree to such cancellation.

MERCHANTS concedes that it did not comply with the cancellation clause in the policy and then proceeds to argue that the cases cited by Pagliero at pages 12 and 13 of his opening brief have no bearing upon this case for, according to MERCHANTS, they deal only with the question of whether or not various cancellation clauses were complied with. It is submitted, however, that these cases are extremely significant, for they hold not only that a cancellation clause is not complied with by the giving of notice to a broker, but that the reason why it is not complied with by the giving of such notice is that the broker was not authorized to receive and act upon it. In the case of *Lauman v. Concordia Fire Insurance Company*, cited supra, for example, the insurance company dealt with the broker just as MERCHANTS dealt with OTIS &

Browne in this case, and the Court held, just as the Court should have held in this case, that the assured was not bound by those dealings, since the brokers had no authority to enter into them. The rule is, of course, the same irrespective of the type of unauthorized action taken by the broker: If he is not authorized to receive a notice of cancellation, he is obviously not authorized, after having received a request from the company that the policy be returned, to agree with the company to a cancellation of the policy.

Merchants' contention that the *Lauman* case and the other cases cited at page 13 of our opening brief are not in point is based upon its contention that Otis & Browne had greater authority than the brokers involved in those cases and accordingly can stand only if the latter contention stands. Similarly, Merchants is justified in relying upon cases in which the broker was actually authorized to agree to a cancellation, only in so far as it first establishes that in this case the brokers had such authority. There is no doubt that many of the cases cited by Merchants would support its position, if the facts in this case were the same as the facts in those cases. It is submitted, however, that extensive and repetitious quotations from such cases have little significance until and unless it is shown that Otis & Browne had the same broad authority that had been given the brokers in those cases. In and of itself the fact that the brokers in the case of *X v. Y* were authorized to agree to a cancellation has no tendency to prove that the brokers in the case of *Pagliero v. Merchants* had such authority.

In the final analysis, and leaving aside for the time being the question of ratification, the issue is whether Otis & Browne were authorized to agree to a cancellation of the policy. Merchants will prevail if, and only if, the record contains evidence of such authority. There is no substitute for such evidence, however, not even the repeated statement that Otis & Browne were general agents for Pagliero, backed up by cases in which the broker concededly was such general agent. It is our position that there is no such evidence in the record and that, in the light of the entire testimony, the answer of Browne to the question of Merchants' counsel as to whether or not he handled Pagliero's entire portfolio cannot be regarded as evidence of the fact that Otis & Browne were Pagliero's general insurance agents.

Merchants recognizes, as of course it must, that the question of whether an agent has ostensible authority to do a certain act is to be determined by the conduct or declarations of the principal and not by the conduct or declarations of the agent. Yet Merchants contends that Otis & Browne had the ostensible authority to agree to a cancellation of the policy, on the ground that Pagliero "intentionally sent them to defendant with evidence of their authority to write endorsements for plaintiffs and as to their supervision of plaintiffs' insurance". (Brief for Appellee, page 22.)

We have already shown that the authority possessed by every broker to prepare endorsements is not the authority to cancel. It can accordingly not be taken

as giving the broker ostensible authority to cancel. As to Pagliero's sending Otis & Browne to Merchants with evidence of their authority to supervise his insurance, we can only respectfully inquire: What evidence?

THE QUESTION OF RATIFICATION.

No attempt is made by Merchants to establish that Pagliero *in fact* ratified the cancellation of the policy and Merchants must accordingly be regarded as having conceded that there was no such ratification.

We established at pages 19 and 20 of our opening brief that the rule which precludes a principal from retaining the benefits of a transaction which his agent was not authorized to enter into, without at the same time shouldering the burden of that transaction, has simply no bearing upon this case, for this case involves two and not one transaction. It was, of course, necessary for Pagliero to ratify the entire transaction with the Home Fire and Marine Insurance Company in order to ratify any part of it, just as it would have been necessary for him to ratify the entire transaction with Merchants, had he wanted to ratify any part of it. The fact, however, that Otis & Browne would not have entered into one transaction, had they not entered into the other, does not compel Pagliero to ratify or reject them together. The cancellation of Merchants' policy was unconditional. Merchants accordingly cannot now contend that its policy was to be cancelled only if that of the Home Fire and Marine

Insurance Company went into effect and that, conversely, since the latter did go into effect, the former was cancelled.

Merchants contends that Pagliero cannot at the same time take advantage of the Home policy and "repudiate and deny the terms under which" that policy was obtained. (Brief for Appellee, page 21.) We have no quarrel with that contention, except that the cancellation of the Merchants' policy was not a *term* of the procurement of the Home policy.

Merchants generously suggests at page 22 of its brief that a different result might be called for, had the Home Fire and Marine Insurance Company repudiated its policy. It is submitted that the result in *this* action cannot thus be made to depend upon the position taken by the Home Fire and Marine Insurance Company as to its policy and that, by suggesting that it can, *Merchants in effect concedes the entire case*. Its contention that Pagliero "ratified" the cancellation is based upon his taking the position that the Home policy was valid. The fact that, after such a "ratification", the Home Fire and Marine Insurance Company might have denied liability on its policy could certainly not result in revoking Pagliero's "ratification". Yet such seems to be Merchants' contention and, better perhaps than anything else, it discloses the fallacy of Merchants' position.

There remains to be discussed the cases which Merchants cites in support of its contention that Pagliero ratified the cancellation of the policy. Since it is not

contended that there was ratification *in fact*, Merchants' position must be taken to be either that the unauthorized procurement of the new policy by Otis & Browne automatically terminated Merchants' liability on its policy, or that Pagliero was called upon to elect between the two policies and, as a matter of law, could not at the same time ratify the unauthorized procurement of the new policy and decline to ratify the unauthorized cancellation of the old policy.

In the case of *Ferrar v. The Western Assurance Company*, 30 Cal. App. 489, 159 Pac. 609, the action was brought against the second company (the Home Fire and Marine Insurance Company in our case) and not, as in our case, against the first company (Merchants). No question of "substitution" was presented, the only issue being as to the extent of the authority of the broker to whom the first company had given notice of cancellation and who subsequently procured the policy sued upon. The Court found the broker to be "her (the insured's) general agent to keep her insured". He was accordingly authorized to accept and act upon a notice of cancellation. In our case, however, *Otis & Browne were not authorized to keep Pagliero insured*. They were accordingly not authorized to accept and act upon a notice of cancellation. As an alternative ground of decision the Court held that the plaintiff ratified the procurement of the new policy. In denying a petition for a hearing, however, the Supreme Court of California stated that it meant to express no view on the question of ratification discussed by the District Court of Appeal, as

a decision on that question was not essential to a determination of the case. The case is accordingly authority only as to the first ground of decision. In so far as the case has any bearing upon our problem, it may be said to support Pagliero's position rather than that of Merchants, since the Court held that the fact that the assured had previously collected from the first company had no bearing upon the determination of the action brought against the second company. That is exactly our contention in this case.

It may be mentioned that Merchants cites the *Ferrar* case for the proposition that California allows ratification after a loss, without indicating, however, that the Supreme Court expressly withheld approval of that part of the decision of the District Court of Appeal.

We already fully discussed in our opening brief the following cases relied upon by Merchants: *Stevenson v. Sun Insurance Office*, 17 Cal. App. 280, 119 Pac. 529; *Finley v. New Brunswick Fire Ins. Co.*, 193 Fed. 195; *Arnfeld v. Guardian Assurance Company of London*, 172 Pa. 605, 34 Atl. 580; *Finley v. Western Empire Ins. Co.*, 69 Wash. 673, 125 Pac. 1012; *Larsen v. Thuringia American Ins. Co.*, 208 Ill. 166, 70 N. E. 31. Nothing said by Merchants as to any of those cases requires further discussion, particularly since we are convinced that this Honorable Court will want to read each of them to determine which of their interpretations is correct.

Nothing need be added either to our analysis of *Strauss v. Dubuque Fire & Marine Insurance Com-*

pany, 132 Cal. App. 283, 22 P. (2d) 582, except to point out that Merchants concedes that the facts which it alleges to have been the facts of that case are not set forth in the opinion. Under such circumstances, the case is obviously not authority for the propositions for which it is cited by Merchants.

No question of whether or not a policy was cancelled is presented in the case of *Walsh v. Tadlock*, 104 Fed. (2d) 131. The case, however, is a rather good example of the application of a principle for which *Pagliero* contends, namely that a party cannot take advantage of part of a transaction entered into by his agent, without being bound by the whole. As distinguished from the situation presented in this case, there was only one transaction and one policy involved in the *Walsh* case.

In the case of *National Fire Insurance Co. v. Oliver* (Texas Civ. App.), 204 S.W. 367, the broker was the agent of both insurance companies and was authorized by the assured to keep him insured up to a certain amount. He was accordingly authorized to accept notice of cancellation. The Court pointed out that the new policy was to become effective only when the effectiveness of the old one ceased, a condition which the broker was of course bound to impose, since he was the agent of both companies, but a condition which was not imposed in this case.

In the case of *A. Davis & Son v. Russian Transport & Insurance Co.*, 169 N.Y.S. 960, the broker was similarly authorized to keep the plaintiff insured up to a

certain amount and was accordingly authorized to accept notice of cancellation in his behalf. Moreover, the part of the opinion quoted at page 44 of the brief for Merchants is pure dictum since the case was decided both in the trial Court and on appeal on the ground that the assured had not submitted proofs of loss within the required 60 days' period.

Thus, our review, both in this and in our opening brief, of the cases relied upon by Merchants discloses that, in addition to other distinguishing features found in some of them, each of them contains one or more of the following features, of which none is found in the present case:

(a) Actual authority of the broker to cancel the policy or general authority to manage all of the assured's insurance business or to keep him insured up to a certain amount.

Finley v. New Brunswick Fire Insurance Co.,
193 Fed. 195;

White v. Insurance Company of New York, 93
Fed. 161;

Ferrar v. The Western Assurance Company, 30
Cal. App. 489, 159 Pac. 609;

Stevenson v. Sun Insurance Office, 17 Cal. App.
280, 119 Pac. 529;

Finley v. Western Empire Ins. Co., 69 Wash.
673, 125 Pac. 1012;

National Fire Ins. Co. v. Oliver (Texas Civ.
App.), 204 S. W. 367;

A. Davis & Son v. Russian Transport & Ins.
Co., 169 N.Y.S. 960.

(b) Ratification in fact of the unauthorized cancellation as distinguished from the ratification as a matter of law which Merchants seeks to impose upon Pagliero as a consequence of his having ratified an entirely separate transaction.

White v. Insurance Company of New York, 93 Fed. 161;

Arnfeld v. Guardian Assurance Company of London, 172 Pa. 605, 34 Atl. 580;

Larsen v. Thuringia American Ins. Co., 208 Ill. 166, 70 N. E. 31.

(c) The broker being the agent for either or both of the insurance companies, with the result that the first company was in effect protected by a condition in the second contract which made the validity of that contract depend upon the termination of the first one.

Finley v. New Brunswick Fire Insurance Co., 193 Fed. 195;

Arnfeld v. Guardian Assurance Company of London, 172 Pa. 605, 34 Atl. 580;

Finley v. Western Empire Ins. Co., 69 Wash. 673, 125 Pac. 1012;

National Fire Ins. Co. v. Oliver (Texas Civ. App.), 204 S. W. 367.

It appears, therefore, that none of the cases cited by Merchants support its position and that a naked and pure doctrine of substitution, under which the procurement of one policy automatically terminates another, simply does not exist. The word is nothing but a convenient catch-all. Before Merchants can be

allowed to use it, however, it must do more than just say "substitution"; it must establish that this case is of a type in which the Courts have allowed the word to be used.

CONCLUSION.

The Home Fire and Marine Insurance Company seems to have a different conception of its duties to its policy holders. Although it might have contended that its own policy was not in effect, since that of Merchants had not been validly cancelled, it chose instead to honor its contract. Pagliero is far from conceding that he would not have been entitled to recover under the Home Fire and Marine Insurance policy, had his rights under that policy been challenged. The liability of *Merchants* remains the same, however, even if it be assumed that the Home Fire and Marine Insurance Company, for reasons of business policy, paid a loss which it did not have to pay.

One word may be added about the contention made at page 21 of the brief for Merchants that to allow Pagliero to recover in this case would in effect allow a "double recovery": Pagliero was damaged in the sum of almost \$465,000 and, to cover that loss, he had policies which, including that of Merchants and that of the Home Fire and Marine Insurance Company, amounted to a total face value of \$315,000.

In the final analysis, this case is one of first impression. None of the cases relied upon by Merchants support its position and it must be conceded that the

cases relied upon by Pagliero can be distinguished to some extent, although several of them stand squarely for the proposition that recovery from one company does not preclude recovery from the other. It is further conceded that the *language* in some cases, as distinguished from the *holding* of those cases, may be unfavorable to Pagliero's position. We need not emphasize, however, that, although it is entitled to respect, the language of a United States District Court or of the Appellate Division of the New York Supreme Court is not binding upon this Honorable Court.

If there is no separate doctrine of substitution, and we submit that there is none, this case turns on the question of prior authority or ratification. Since the cancellation clause was not complied with and Pagliero neither agreed to a cancellation nor authorized Otis & Browne to agree thereto, nor ratified any agreement cancelling the policy, the judgment should be reversed.

Dated, San Francisco, California,
May 10, 1948.

Respectfully submitted,
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Attorneys for Appellants.

No. 11832

IN THE

United States Circuit Court of Appeals
FOR THE NINTH CIRCUIT

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of COLUSA REMEDY COMPANY, and COLUSA REMEDY COMPANY, a corporation,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

TRANSCRIPT OF RECORD

Upon Appeal From the District Court of the United States
for the Southern District of California

Central Division

FILED

MAY 24 1946

PAUL P. O'BRIEN,
CLERK

No. 11832

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INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italics; and likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible an omission from the text is indicated by printing in italics the two words between which the omission seems to occur.]

| | Page |
|--|------|
| Affidavit in Support of Petition for Extension of Time to File Record and Docket Appeal (Circuit Court) | 42 |
| Appeal: | |
| Affidavit in Support of Petition for Extension of Time to File Record and Docket (Circuit Court) | 42 |
| Notice of | 39 |
| Petition for Order and Order for Extension of Time to File Record and Docket (Circuit Court)..... | 41 |
| Points Upon Which Appellant Intends to Rely on (Circuit Court) | 82 |
| Certificate of Clerk..... | 44 |
| Exhibits (See Index to Exhibits) | |
| Information re Contempt..... | 2 |
| Judgment and Commitment—Chester Walker Col- grove | 36 |
| Judgment and Commitment—Colusa Remedy Com- pany | 34 |
| Minute Order Entered December 8, 1947, Waiving Jury | 17 |
| Minute Order Entered December 19, 1947, on Trial.... | 27 |
| Minute Order Entered January 5, 1948, Pronouncing Judgment | 33 |
| Minute Order Entered January 19, 1948, re Depositing of Cash | 40 |
| Names and Addresses of Attorneys..... | 1 |
| Notice of Appeal..... | 39 |

| | Page |
|---|------|
| Order Extending Time to File Record on Appeal and Docket Appeal (Circuit Court)..... | 42 |
| Order to Show Cause re Criminal Contempt..... | 16 |
| Petition for Order for Extension of Time to File Record and Docket Appeal (Circuit Court)..... | 41 |
| Points Upon Which Appellant Intends to Rely on Ap- peal (Circuit Court)..... | 82 |
| Reporter's Transcript of Proceedings..... | 45 |
| Defendants' Exhibits (See Index to Exhibits) | |
| Plaintiff's Exhibits (See Index to Exhibits) | |
| Testimony on Behalf of Defendant: | |
| Colgrove, Chester Walker— | |
| Direct examination | 56 |
| Cross-examination | 64 |
| Waiver of Trial by Jury and of Special Findings..... | 25 |

INDEX TO EXHIBITS

Plaintiff's Exhibits:

| No. | | Page |
|-----|---|----------|
| 1. | Advertisement (In Evidence)..... (In Transcript) | 47 19 |
| 2. | Label (In Evidence)..... (In Transcript) | 48 22 |
| 3. | Label (In Evidence)..... (In Transcript) | 49 23 |
| 4. | Stipulation of Facts (For Identification)..... (In Transcript) | 49 23 |

Defendants' Exhibits:

| | | |
|----|--|----|
| A. | Railway Express Agency correspondence (In Transcript) | 28 |
| B. | Advertisement (In Transcript)..... | 29 |

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In the District Court of the United States in and for the
Southern District of California
Central Division

No. 19575

UNITED STATES OF AMERICA,

Plaintiff,

v.

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of COLUSA REMEDY COMPANY, and COLUSA REMEDY COMPANY, a Nevada corporation,

Defendants.

INFORMATION RE CONTEMPT (CRIMINAL)
[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

(Injunctions issued by this Court on February 24 and April 23, 1947, No. 5992-WM Civil)

The United States Attorney Charges:

COUNT ONE

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on February 24, 1947, this Court issued a writ of preliminary injunction against Chester Walker Colgrove, trading and doing business under the firm name of Colusa Remedy Company, and against the Colusa Remedy Company, a Nevada corporation. [No. 5992-WM Civil.]

That said injunction restrained the defendants from further violating the Federal Food, Drug, and Cosmetic Act. Defendants were therein enjoined

"from introducing or delivering for introduction into interstate commerce, in any form or manner, the

product known as 'Colusa Natural Oil', or any like product, without a label containing specific directions for the use of such product in the treatment of all conditions, ills and diseases for which such product is prescribed, recommended, and suggested, in the advertising material disseminated or sponsored by or on behalf of the defendants or either of them; which directions shall include the quantity of the dose (including quantities for [2] persons of different ages and different physical conditions) to be taken or applied in the treatment of each of such conditions, ills and diseases, as well as the recommended frequency and duration of administration or application of such dosage."

That on February 26, 1947, the United States Marshal served defendants with a copy of said writ of preliminary injunction.

That on April 14, 1947, this Court granted and on April 23, 1947, issued a permanent injunction with the written and signed consent of the defendants. On April 25, 1947, the United States Marshal served the defendants with a copy of said writ of permanent injunction. The significant language of said permanent injunction is identical with that quoted above from the preliminary injunction, except that the word "adequate" is substituted for the word "specific".

That on April 2, 1947, after the preliminary injunction had been issued, defendants wrote to Schlitz Bros. Drug, Appleton, Wisconsin, as follows:

"Our experience shows April, May and June to be outstandingly the best three months of the year for Colusa sales, so I have ordered advertising resumed

in your local paper over your name and will continue it throughout the period, starting off with that big adv., 2 column wide and 16 inches long, the one that sold out so many complete stocks of Colusa in numerous stores within the first 48 hours . . . This big adv. will be followed by smaller copy."

That on April 1, 1947, defendants shipped from Los Angeles, California, to said Schlitz Bros. Drug, Appleton, Wisconsin, a consignment of Colusa Natural Oil which bore labels reading in part as follows:

"A natural unrefined petroleum oil intended for use in the treatment of Psoriasis, Eczema, Athlete's Foot, and Leg Ulcers.

"Directions: Apply to affected parts and rub it in thoroughly morning and night. For open sores, saturate cotton pad with oil and bind on by gauze. Change to fresh dressing morning and night. For tender skin oil can be diluted 50% with olive [3] oil. Continue treatment until skin is smooth and comfortable . . ."

That the advertisements alluded to in defendants' letter of April 2, 1947, appeared on April 24 and June 4, 1947 in the Appleton Post-Crescent, Appleton, Wisconsin, giving the name and address of Colusa Remedy Company and Schlitz Bros. Drug.

Said advertisements prescribe, recommend, and suggest Colusa Natural Oil as highly efficacious not only for psoriasis, athlete's foot, eczema, and leg ulcers (the four disease conditions mentioned on the label of said drug) but also for poison ivy, poison oak, bed sores, acne, ring-worm, scaly red face, burns, piles, and itch.

That the labels on defendants' product, as shipped to said Schlitz Bros. Drug, on April 1, 1947, disregarded the requirements of the aforesaid preliminary injunction since they fail even to attempt to bear specific directions for use of the product in the treatment of all ills, conditions, and diseases for which the product is prescribed, recommended and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of the said shipment of April 1, 1947, the defendants are in criminal contempt of the preliminary injunction issued by this Court as aforesaid. [4]

COUNT TWO

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on May 6, 1947, defendants shipped from Los Angeles, California, to the same Schlitz Bros. Drug, Appleton, Wisconsin, that is referred to in Count One, a consignment of Colusa Natural Oil which bore label statements identical with those quoted in Count One, which label statements are hereby incorporated into this Count by reference.

That the description of the defendants' letter to said Schlitz Bros. Drug and of the advertisements in the Appleton Post-Crescent, Appleton, Wisconsin, as given in Count One, is applicable to said shipment and is hereby incorporated into this Count by reference.

That the labels on defendants' product, as shipped to said Schlitz Bros. Drug on May 6, 1947, disregard the requirements of the permanent injunction described in Count One since they fail even to attempt to bear adequate directions for use of the product in the treatment of all ills, conditions and diseases for which the product

is prescribed, recommended and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of said shipment of May 6, 1947, the defendants are in criminal contempt of the permanent injunction issued by this Court and described in Count One, which injunction is hereby incorporated into this Count by reference. [5]

COUNT THREE

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on July 9, 1947, defendants shipped from Los Angeles, California, to the same Schlitz Bros. Drug, Appleton, Wisconsin, that is referred to in Count One, a consignment of Colusa Natural Oil which bore label statements identical with those quoted in Count One, which label statements are hereby incorporated into this Count by reference.

That the description of the defendants' letter to said Schlitz Bros. Drug, and of the advertisements in the Appleton Post-Crescent, Appleton, Wisconsin, as given in Count One, is applicable to said shipment and is hereby incorporated into this Count by reference.

That the labels on defendants' product, as shipped to said Schlitz Bros. Drug on July 9, 1947, disregard the requirements of the permanent injunction described in Count I since they fail even to attempt to bear adequate directions for use of the product in the treatment of all ills, conditions, and diseases for which the product is prescribed, recommended, and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of said shipment of July 9, 1947, the defendants are in criminal contempt of the permanent injunction issued by this Court and described in Count One, which injunction is hereby incorporated into this Count by reference. [6]

COUNT FOUR

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on April 17, 1947, defendants wrote to Crescent Drug, Walla Walla, Washington, as follows:

"I have ordered the 2-col. x 16" adv. run in your paper next week—the one that has pulled so well. I am trying to do this for all my good customers this month and first half of next . . ."

That on April 17, 1947, defendants shipped from Los Angeles, California, to said Crescent Drug, Walla Walla, Washington, a consignment of Colusa Natural Oil which bore label statements identical with those quoted in Count One, which label statements are hereby incorporated into this Count by reference.

That the advertisement alluded to in defendants' letter of April 17, 1947 appeared on April 23, 1947, in the Walla Walla Union-Bulletin, Walla Walla, Washington, giving the name and address of Colusa Remedy Company and Crescent Drug. Said advertisement prescribes, recommends, and suggests Colusa Natural Oil as highly efficacious not only for psoriasis, athlete's foot, eczema, and leg ulcers (the four disease conditions mentioned on the label of said drug) but also for poison ivy, poison oak, bed sores, acne, ringworm, scaly red face, burns, piles and itch.

That the labels on defendants' product, as shipped to said Crescent Drug, disregard the requirements of the preliminary and permanent injunctions described in Count One, since they fail even to attempt to bear specific or adequate directions for use of the product in the treatment of all ills, conditions and diseases for which the product is prescribed, recommended and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of the said shipment of April 17, 1947, the defendants are in criminal contempt of the preliminary injunction and the permanent injunction issued by this Court and described in Count One, which injunctions are hereby incorporated into this Count by reference [7]

COUNT FIVE

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on April 2, 1947, defendants wrote to William H. McNeill, Druggist, Godwin and Franklin Avenue, Midland Park, New Jersey, as follows:

"Our experience shows April, May and June to be outstandingly the best three months of the year for Colusa sales, so I have ordered advertising resumed in your local paper over your name and will continue it throughout the period, starting off with that big adv., 2 columns wide and 16 inches long, the one that sold out so many complete stocks of Colusa in numerous stores within the first 48 hours . . . This big adv. will be followed by smaller copy."

That on April 5, 1947, defendants shipped from Los Angeles, California, to said William H. McNeill, Mid-

land Park, New Jersey, a consignment of Colusa Natural Oil which bore label statements identical with those quoted in Count One, which label statements are hereby incorporated into this Count by reference.

That one of the advertisements alluded to in defendants' letter of April 2, 1947, appeared on June 12, 1947, in the Ridgewood Herald-News, Ridgewood, New Jersey, giving the name and address of Colusa Remedy Company and William H. McNeill. Said advertisement prescribes, recommends, and suggests Colusa Natural Oil as highly efficacious not only for psoriasis, athlete's foot, eczema, and leg ulcers (the four disease conditions mentioned on the label of said drug) but also for poison ivy, poison oak, bed sores, acne, ringworm, scaly red face, burns, piles and itch.

That the labels on defendants' product, as shipped to said William H. McNeill, disregard the requirements of the preliminary injunction described in Count One, since they fail even to attempt to bear specific directions for use of the product in the treatment of all ills, conditions, and diseases for which the product is prescribed, recommended, and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of the said shipment of April 5, 1947, the defendants are in [8] criminal contempt of the preliminary injunction issued by this Court and described in Count One, which injunction is hereby incorporated into this Count by reference. [9]

COUNT SIX

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on or about June 16, 1947, defendants wrote to Rands Drug, Inc., 225 Ross, Pittsburgh, Pennsylvania, as follows:

"Pursuant to my letter of last week I have ordered the large 2-col. x 16" adv. published early next week in the following papers:

"Pittsburgh Post Gazette
" Sun Telegraph
Beaver Falls, Pa. Tribune
Greensburg, Pa. Review
New Castle, Pa. News
Ambridge, Pa. Daily Citizen
Morgantown, W. Va. Post
Fairmont, W. Va. Times
Clarksburg, W. Va. Telegram
East Liverpool, Ohio Review
Hagerstown Daily Mail
Cumberland, Md. Times

"All of course will be published over your store name and address except in Pittsburgh where reference will read:

'Sold by all Rands Drug Stores.'

"I have shipped to each of the smaller cities by prepaid express a small quantity as shown on enclosed consignment invoices."

That on May 3, 1947, defendants shipped from Los Angeles, California, to said Rands Drug, Inc., 225 Ross Street, Pittsburgh, Pennsylvania, a consignment of Colusa Natural Oil which bore label statements identical with

those quoted in Count One, which label statements are hereby incorporated into this Count by reference.

That one of the advertisements alluded to in defendants' letter of June 16, 1947, appeared on June 28, 1947, in the Pittsburgh Post-Gazette. Said advertisement prescribes, recommends, and suggests Colusa Natural Oil as highly efficacious not only for psoriasis, athlete's foot, eczema, and leg ulcers (the four disease conditions mentioned on the label of said drug) but also for poison ivy, poison oak, bed sores, acne, ringworm, scaly red face, burns, piles and itch.

That the labels on defendants' product, as shipped to said Rands Drug, Inc., disregarded the requirements of the permanent injunction described in Count One since they fail even to attempt to bear adequate directions for use of the product in the treatment of all ills, conditions, and diseases for which the product is prescribed, recommended, and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of the said shipment of May 3, 1947, the defendants are in criminal contempt of the permanent injunction issued by this Court and described in Count One, which injunction is hereby incorporated into this Count by reference. [11]

COUNT SEVEN

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on April 28, 1947, defendants wrote to Ballou-Latimer Drug, Boise, Idaho, as follows:

"Our experience shows April, May and June to be outstandingly the best three months of the year for Colusa sales, so I have ordered advertising re-

sumed in your local paper over your name and will continue it throughout the period, starting off with that big adv., 2 columns wide and 16 inches long, the one that sold out so many complete stocks of Colusa in numerous stores within the first 48 hours This big adv. will be followed by smaller copy."

That on April 28, 1947, defendants shipped from Los Angeles, California, to said Ballou-Latimer Drug, 826 Idaho Street, Boise, Idaho, a consignment of Colusa Natural Oil which bore label statements identical with those quoted in Count One, which label statements are hereby incorporated into this Count by reference.

That the advertisements alluded to in defendants' letter of April 28, 1947, appeared on May 7, 1947 and June 4, 1947 in The Idaho Daily Statesman, Boise, Idaho, giving the name and address of Colusa Remedy Company and Ballou-Latimer Drug. Said advertisements prescribe, recommend and suggest Colusa Natural Oil as highly efficacious not only for psoriasis, athlete's foot, eczema, and leg ulcers (the four disease conditions mentioned on the label of said drug) but also for poison ivy, poison oak, bed sores, acne, ringworm, scaly red face, burns, piles, and itch.

That the labels on defendants' product, as shipped to said Ballou-Latimer Drug, disregard the requirements of the permanent injunction described in Count One since they fail even to attempt to bear adequate directions for use of the product in the treatment of all ills, conditions, and diseases for which the product is prescribed, recommended, and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of said shipment of April 28, 1947, the defendants are in [12] criminal contempt of the permanent injunction issued by this Court and described in Count One, which injunction is hereby incorporated into this Count by reference. [13]

COUNT EIGHT

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on April 2, 1947, defendants wrote to Thrifty Drug Store, 114 Broadway, Rochester, Minnesota, as follows:

“Our experience shows April, May and June to be outstandingly the best three months of the year for Colusa sales, so I have ordered advertising resumed in your local paper over your name and will continue it throughout the period, starting off with that big adv., 2 columns wide and 16 inches long, the one that sold out so many complete stocks of Colusa in numerous stores within the first 48 hours . . . This big adv. will be followed by smaller copy.”

That on or about May 27, 1947, defendants shipped from Los Angeles, California, to said Thrifty Drug Store, 114 Broadway, Rochester, Minnesota, a consignment of Colusa Natural Oil which bore label statements identical with those quoted in Count One, which label statements are hereby incorporated into this Count by reference.

That one of the advertisements alluded to in defendants' letter of April 2, 1947, appeared on May 15, 1947, in the Rochester Post-Bulletin, Rochester, Minnesota. Said advertisement prescribes, recommends, and suggests Colusa Natural Oil as highly efficacious not only for

psoriasis, athlete's foot, eczema, and leg ulcers (the four disease conditions mentioned on the label of said drug) but also for poison ivy, poison oak, bed sores, acne, ringworm, scaly red face, burns, piles and itch.

That the labels on defendants' product, as shipped to said Thrifty Drug Store, disregard the requirements of the permanent injunction described in Count One since they fail even to attempt to bear adequate directions for use of the product in the treatment of all ills, conditions, and diseases for which the product is prescribed, recommended, and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of said shipment of May 27, 1947, the defendants are in [14] criminal contempt of the permanent injunction issued by this Court and described in Count One, which injunction is hereby incorporated into this Count by reference. [15]

COUNT NINE

[21 U. S. C. A., §332(b) and 28 U. S. C. A., §387]

That on or about June 6, 1947, the defendants caused to be shipped from Philadelphia, Pennsylvania, consigned to Colusa Remedy Company, Los Angeles, California, certain quantities of the drug "Colusa Natural Oil".

That the labels affixed to said drug failed to state any disease condition for which the drug was to be used.

That, as alleged in Counts One to Eight inclusive, defendants have caused advertisements of said drug to appear in newspapers in various parts of the United States, which advertisements prescribe, recommend and suggest Colusa Natural Oil as highly efficacious for psoriasis, athlete's foot, eczema, leg ulcers, poison ivy, poison oak,

bed sores, acne, ringworm, scaly red face, burns, piles, and itch. Excerpts from these advertisements, as quoted in Counts One to Eight inclusive, are hereby incorporated into this Count by reference. Such an advertisement appeared in the Los Angeles Herald-Express, Los Angeles, California, on August 12, 1947.

That the aforesaid labels on defendants' product disregard the requirements of the permanent injunction described in Count One since they fail even to attempt to bear adequate directions for use of the product in the treatment of all ills, conditions, and diseases for which the product is prescribed, recommended, and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of said shipment of June 6, 1947, the defendants are in criminal contempt of the permanent injunction issued by this Court and described in Count One, which injunction is hereby incorporated into this Count by reference.

Wherefore, the United States Attorney requests that an Order to Show Cause issue out of this Court directing the said Chester Walker Colgrove and Colusa Remedy Company to show cause on a day certain before this Honorable Court why they should not be adjudged in criminal contempt of this Court by reason of the violations of the preliminary and permanent injunctions herein alleged.

JAMES M. CARTER
United States Attorney

[Endorsed]: Filed Oct. 2, 1947. Edmund L. Smith,
Clerk. [16]

[Title of District Court and Cause]

ORDER TO SHOW CAUSE RE CRIMINAL
CONTEMPT

Upon the Information of the United States Attorney filed in this Court this 3 day of October, 1947, alleging that Chester Walker Colgrove and the Colusa Remedy Company disobeyed lawful decrees and commands of this Court in that they introduced into interstate commerce shipments of Colusa Natural Oil and the labels affixed to such product did not bear specific or adequate directions for use of the product in the treatment of all ills, conditions, and diseases for which the product is prescribed, recommended, and suggested in the advertising material disseminated and sponsored by the defendants;

It Is Ordered By the Court that the said Chester Walker Colgrove and Colusa Remedy Company appear and show cause at 10 A. M., on the 16 day of October, 1947, before this Court in the United States Post Office and Court House in the City of Los Angeles, State of California, why an order should not be made adjudging the said Chester Walker Colgrove and Colusa Remedy Company in criminal contempt of this Court; [17]

And It Is Further Ordered that the service of a copy of this Order by the United States Marshal, or one of his deputies, together with a copy of the said Information be made upon the said Chester Walker Colgrove and Colusa Remedy Company on or before the 6 day of Oc-

tober, 1947, and that the same shall be due and sufficient service of the Order to Show Cause.

October 3, 1947.

WM. C. MATHES

United States District Judge

[Endorsed]: Filed Oct. 3, 1947. Edmund L. Smith,
Clerk. [18]

[Minutes: Monday, December 8, 1947]

Present: The Honorable Wm. C. Mathes, District
Judge.

For hearing on return of order of Oct. 3, 1947, to de-
fendants to show cause why they should not be punished
for contempt; D. G. Klinger, Ass't U. S. Atty's, present
for Gov't; Eugene McGann, Esq., present for defendants;

Plfs.' Ex. 1, 2, 3, 4 are admitted in evidence. Attorney
McGann makes a statement for respondent. Court finds
defendants have not purged themselves of contempt and
set cause for trial Dec. 19, 1947, 10 A. M. Jury is waived.

Def't Colgrove, who is present, is advised of said trial
date. [19]

THE RIDGEWOOD HERALD-NEWS, THURSDAY, JUNE 12, 1947

[PLAINTIFF'S EXHIBIT NO. 1]

20

and other writings of our Puritan Forefathers.

SKIN SUFFERERS

**READ HOW AN INVISIBLE OF A PRODUCT FROM THE EARTH
QUICKLY RELIEVED HUNDREDS FROM MISERY OF
PSORIASIS • ATHLETES FOOT • and**



**LEG ULCERS-
SUMMARY OF CLINICAL REPORTS ON 28 CASES**

A doctor who does a medical examination of all the cases of sprains, complete or incomplete, and continues treatment of cases as long as the principles of the treatment are not out of the power of athletes foot, one who did not return for treatment were dismissed completely cured—5 to 14 days for adult cases and 3 weeks for children. The treatment is a poultice made of a mutton fat, oil and salve, which is applied to the feet in an adhesive bandage. His examinations are conducted in his office group and individual treatment is bad. The treatment of athlete's foot in China may be used for the eyes with great success, according to Dr. H. A. G. Smith, a member of the Chinese delegation. A single dose of the ointment is to treat the eyes, stimulating, soothing to the eyes and eliminating, said a medical professor. It may also be used to the nose and throat to make varicose glowering and hemorrhoids disappear. Good consumer health education is important on 25 January and like other American Government health education organizations it is under

Thousands of DOCTORS Are COLUSA Customers

EXCERPTS FROM A FEW OF THEIR REPORTS

NEW YORK—Dr. C. practiced 10 years. (Case a) "Blisters of sharp pointed knobs" by getting Water. (Case b) "A large number of vesicles and pustules" on face and body. (Case c) "A large number of vesicles and pustules" cleared in 6 weeks. (Case d) "Pustules on an entire body" vesicular and swelling. (Case e) "vesicular and crusty blisters" on face and entire body cleared in 8 days. (Case f) "Asthenic low fever" vesicular; wear shoes for 3 weeks. Entombed in 10 days. (Other cases) Low fever 2 weeks, blisters cleared in 3 weeks with Coxsackie B. Had some standing sores gone in 1 week and more healing power. I have used Coxsackie B. for burns and peptic ulcers with excellent results.

TEXAS—Dr. B. practiced 42 years. Two cases of general results were fine. Three cases of local results good, seem to be improving.

DR. H.—practiced 44 years. (Case a) "Pustules on nose, case cleared of all signs in two months." (Case b) Acne. 3 cases, all improving. (Case c) "One ulcer on nose, one on ear, both cleared." (Case d) "Wife sick." In 10 days cleared 50%.

DR. J.—practiced 39 years. Cases a, b, c, d, e, f. Half hour and seems for 6 weeks and of a severe outbreak but, no new cases. (Case g) "A patient who has passed the measles and B continue to have recurrent taking place since using Coxsackie B."

MARYLAND—Dr. K. practiced 34 years. (Case a) "Fever and constitutional results." Patient recovered. (Case b) "Ringworm." Case quickly recovered.

DRUGGISTS IN 17 STATES REPORT 89 STUBBORN CASES WHERE COLUSA SUCCEEDED AFTER OTHER MEDICINES AND DOCTORING FAILED

Thousands of USERS WRITE LETTERS of PRAISE

EXCERPTS FROM A FEW USERS' LETTERS

C. H. G., California - Colitis has produced some wonders for me as I have had a very bad case of eczema which would not go away and the skin on my hands became a crust which would crack very easily. I used to have frequent and severe attacks of eczema in the first ten years. In 40 years my hands have been healed the skin became so soft and healthy that you can hardly believe it now when you see me. **PROGRESSIVE**

B. B. S., California - Colitis and constipation have been a problem to me for many years. I have had 1000 cases of patients that I have had for 30 years. Doctors failed to cure me. Your Colon oil and casein diet cured me.

J. E. L., New York City - I tried Colon oil and casein diet and was treated first with a diet supervised by Dr. Maxine. Then I had a special diet supervised by Dr. Maxine in Chicago and then to Rochester Minn. and I received your natural oil completely cleared up my trouble in three weeks and I have not had any signs of recurrence.

March 26, 1942 - It began showing results after the first 3 applications. Now I would say it is cured and I now eat 3 meals without any complaints.

L. E. L., Calif. - I tried Colon oil and casein diet and the results were most surprising at first. I must say it is the best diet I have ever had.

ARMED GUARDS TO DRUGISTS AND DOCTORS

... a money-back guaranty
have for thousands of
good pleasure results.

11 Ph

MIDLAND PARK, N.J.
SELLS DRUGS

Remedy Co., 1507 N. Wild

Case No. 19575. U. S. vs. Colusa. Pltf. Exhibit 1 on hrg on rt OSC. Date 12/8/47. No. 1 in Evidence. Clerk, U. S. District Court, Sou. Dist. of Calif. Louis J. Somers, Deputy Clerk.

Case No. 19575 Crim. U. S. A. vs. Chester W. Colgrove, Plf. Exhibit 1. Date 12-19-47. No. 1 in Evidence. Clerk. U. S. District Court, Sou. Dist. of Calif. John A. Childress, Deputy Clerk. [21]

[PLAINTIFF'S EXHIBIT NO. 2]

(Label on Bottle)

COLUSA
NATURAL OIL

A natural unrefined petroleum oil intended for use in treatment of Psoriasis, Eczema, Athlete's Foot and Leg Ulcers.

Directions: Apply to affected parts and rub it in thoroughly morning and night. For open sores satuate cotton pad with oil and bind on by gauze. Change to fresh dressing morning and night. For tender skin oil can be diluted 50% with olive oil. Continue treatment until skin is smooth and comfortable. We suggest in treatment of Psoriasis, Eczema and Leg Ulcers using Colusa Natural Oil externally as above directed and Colusa Natural Oil capsules internally as directed on bottle containing Colusa Natural Oil capsules.

Net contents 2 fl. oz.

COLUSA REMEDY CO.
1507 North Wilcox Avenue
Los Angeles, California

Case No. 19575-Cr. U. S. A. vs. Colusa et al. Pltf. Exhibit 2 in Evidence. Date 12-8-47. Clerk, U. S. Dist. Court, Sou. Dist. of Calif. Louis J. Somers, Deputy Clerk. (Label on O. S. C.)

Case No. 19575-WM. U. S. A. vs. Chester W. Colgrove. Govt. Exhibit 2 in Evidence. Date 12-19-47. Clerk, U. S. District Court, Sou. Dist. of Calif. John A. Chil-dress, Deputy Clerk. [22]

[PLAINTIFF'S EXHIBIT NO. 3]

(Label on Bottle)

COLUSA
NATURAL OIL
A Natural Unrefined Petroleum Oil

Directions: Apply to affected parts and rub it in thoroughly morning and night. For open sores saturate cotton pad with oil and bind on by gauze. Change to fresh dressing morning and night. For tender skin oil can be diluted 50% with olive oil.

Net contents 2 Fl. ozs.

COLUSA REMEDY CO.
1507 North Wilcox Ave.
Los Angeles, Calif.

Case No. 19575-WM. U. S. A. vs. Chester W. Colgrove. Govt. Exhibit 3 in Evidence. Date 12-19-47. Clerk, U. S. District Court, Sou. Dist. of Calif. John A. Childress, Deputy Clerk. [23]

[PLAINTIFF'S EXHIBIT NO. 4]

In the District Court of the United States in and for the Southern District of California, Central Division

United States of America, Plaintiff, v. Chester Walker Colgrove, trading and doing business under the firm name of Colusa Remedy Company, and Colusa Remedy Company, a Nevada Corporation, Defendants. No. 19575

STIPULATION

It is hereby stipulated and agreed by and between the parties to this criminal contempt action:

- (1) That all of the facts set forth in the Criminal Information are true, except that it is not admitted that the advertisements referred to in said Information prescribe, recommend and suggest Colusa Natural Oil in the treatment of poison ivy, poison oak, bed sores, acne, ringworm, scaly red face, burns, piles, and itch.
- (2) That the attached newspaper advertisement taken from page 8 of the June 12, 1947, issue of The Ridgewood Herald-News, Ridgewood, New Jersey, and identified as Exhibit A, is typical of the advertisements referred to in said Information.
- (3) That the label on the bottle of Colusa Natural Oil identified [24] as Exhibit B is representative of the labels referred to in Counts 1-8 of the Information.
- (4) That the label on the bottle of Colusa Natural Oil identified as Exhibit C is representative of the labels referred to in Count 9 of the Information.

Dated: This 8th day of December, 1947.

CHESTER WALKER COLGROVE,
trading and doing business under the firm
name and style of Colusa Remedy Co.
By Eugene T. McGann
Attorney for Defendant Colgrove
COLUSA REMEDY COMPANY,
a Nevada Corporation
C. W. Colgrove
Pres.

UNITED STATES OF AMERICA

JAMES M. CARTER

United States Attorney

By T. G. Klinger

T. G. Klinger

Special Assistant to the U. S. Attorney

Attorneys for the Plaintiff

Case No. 19575. U. S. vs. Colusa. Pltf. Exhibit 4.
Date 12/8/47. No. 4 in Evidence. Clerk, U. S. District
Court, Sou. Dist. of Calif. Louis J. Somers, Deputy
Clerk. [25]

[Title of District Court and Cause]

WAIVER OF TRIAL BY JURY
and

WAIVER OF SPECIAL FINDINGS OF FACT
(Rule 23(a) and (c) F. R. C. P.)

The undersigned defendant hereby waives the right to a trial by jury and requests the court to try all charges against him in this cause without a jury.

The undersigned defendant further waives the right to request any special findings of fact as provided by Rule 23(c) of the Federal Rules of Criminal Procedure.

December 8, 1947.

COLUSA REMEDY CO.

By C. M. Colgrove, Pres.

Defendant

CHESTER WALKER COLGROVE

The undersigned counsellor represents that prior to the signing of the foregoing waiver, the defendant was fully advised as to the rights of an accused under the Constitution and laws of the United States, including the right to a trial by jury and the right to request special findings in a case tried without a jury; and further represents that, in his opinion, the above waiver by the defendant of trial by jury and special findings is voluntarily and understandingly made.

December 8, 1947.

EUGENE T. McGANN
Attorney for Defendant

The United States Attorney hereby consents that the case be tried without a jury, and waives the right to request any special findings of fact as provided by Rule 23(c) of the Federal Rules of Criminal Procedure.

December 8, 1947.

JAMES M. CARTER
United States Attorney
By Tobias G. Klinger
Assistant U. S. Attorney

Approved December 19, 1947.

WM. C. MATHES
United States District Judge

[Endorsed]: Filed Dec. 8, 1947. Edmund L. Smith,
Clerk. [26]

[Minutes: Friday, December 19, 1947]

Present: The Honorable Wm. C. Mathes, District Judge.

For trial; T. G. Klinger, Ass't U. S. Att'y, present for Gov't; E. T. McGann, Esq., present for defendant Chester Walker Colgrove, who is present on O/R; counsel stipulate that Gov't Ex. 1, 2, and 3, heretofore introduced on hearing of Order to Show Cause, Dec. 8, 1947, be deemed admitted for trial, and it is so ordered. Gov't rests.

Chester Walker Colgrove is called, sworn, and testifies in his own behalf. Deft's Ex. A and B are admitted in evidence. Defendant rests.

Attorneys Klinger and McGann argue to the Court.

Court finds Def't Colgrove guilty of contempt as charged in counts 1 to 8 inclusive and not guilty as charged in count 9.

Court finds defendant Colusa Remedy Co. guilty of contempt as charged in counts 1 to 8 inclusive and not guilty as charged in count 9.

Court orders cause referred to Prob. Officer for investigation and report as to both defendants and continued to Jan. 5, 1948, 1:30 P. M., for hearing said reports and sentence, and that meantime Def't Colgrove remain on O/R. [27]

[DEFENDANTS' EXHIBIT A]

[Crest] RAILWAY EXPRESS AGENCY [Crest]
Incorporated
6611 Santa Monica Blvd.
Hollywood, California

R. L. Van Houten,
General Agent

Tel. Hillside 6171

June 18, 1947

Colusa Remedy Co.
1507 North Wilcox
Hollywood, Calif.

Gentlemen:

We have received a shipment from C. W. Colgrove, Philadelphia, Penn., being a return shipment which you forwarded from here on prepaid receipt 5354, October 2nd, 1946.

Bureau of Food and Drug Inspector, Milton P. Duffy, has placed against this shipment a quarantine preventing the delivery of the material to your address.

Shipment consists of sixteen cartons.

Yours very truly,

R. L. Van Houten

R. L. Van Houten

RLV:js

General Agent

Case No. 19575 Crim. U. S. A. vs. Chester W. Colgrove. Dft. Exhibit A. Date 12-19-47. Exhibit A in Evidence. Clerk, U. S. District Court, Sou. Dist. of Calif. John A. Childress, Deputy Clerk. [28]

[DEFENDANTS' EXHIBIT B]

29

10 Winfield Daily Courier, Wednesday, April 16, 1947

| | |
|-----------------|--------------------------------------|
| Advances | Winfield Markets |
| | Wheat, bu. _____ \$2.24 |
| | Mill run feed, cwt. retail _____ 32¢ |
| | Winfield Produce Market |



SKIN SUFFERERS

**READ HOW SIMPLE USE OF A PRODUCT FROM THE EARTH
QUICKLY RELEASED HUNDREDS FROM MISERY OF
PSORIASIS • ATHLETES FOOT • and**



ECZEMA- BEFORE AND 12 DAYS AFTER STARTING TO USE COLUSA NATURAL OIL AND CAPSULES



www.mindbodyon.com/CAFFEE

LEW ULLERS SUMMARY

A total of 1,000 cases of dengue fever were reported in Texas during an average of 5 days. His report was based on an average of 100 cases per day.

**Thousands of Doctors are using
SUCROSE FROM A FEW OF THEIR REPORTS**

EXCERPTS FROM A FEW OF THEIR REPORTS

**DRUGISTS IN 17 STATES REPORT 89 STUBBORN CASES WHERE
THERAPEUTIC SALES**

EXCERPTS FROM REPORTS BY DRUGGISTS

L USERS WRITE LETTERS of PRAISE

Thousands of users write letters of praise.
EXCERPTS FROM A FEW USERS' LETTERS

Eczema - I am Product No. 1000 with what I call an itch, during which time I have

B. B. California: I am on and can
not leave you now. The
people here are very kind, and
I have a good time. I am
writing to you every day, and
will send you my letters
as soon as possible. Please
write back to me, and tell me
about your life in America.
ITC

CLINICAL DIAGNOSTICS AND DOCTORS

WE SELL ONLY TO DRUGGISTS AND DOCTORS

Try Colusa Natural Ointment - it has been used by thousands of others. If you are not astonished by quick and pleasing results, we suggest a refund of your money upon return of unused portion within thirty days.

Sold in Winfield By

MELL BACKUS PHARMACY, 809 Main St.

COLUSA REMEDY CO., 1507 N. Wilcox Ave., Los Angeles 28, C

Letters making correction on mats

| | |
|----------------------------|-------------------------|
| The Messenger | St. Albans, Vt. |
| Midland Newspaper | Midland Park, N. J. |
| Woodland Newspaper | Woodland, Me. |
| Bellefonte | " |
| Kingston | " |
| The Times | Kingston, Pa. |
| Evening Times | Gettysburg, Pa. |
| Dover Newspaper | Sayre, Pa. |
| Lowville | Dover, N. J. |
| The Sun | Lowville, N. Y. |
| Harriman | Jamestown, N. Dak. |
| Plainview Herald | Harriman, Tenn. |
| Raymondsville Newspaper | Plainview, Tex. |
| The Advocate | Raymondsville, Tex. |
| The News | Victoria " " |
| The Courier | Bicknell, Ind. |
| Junction City Newspaper | Winfield, Kans. |
| Roanoke Rapids | Junction City, Ark. |
| The Reporter | Roanoke Rapids, N. Car. |
| Telegraph Forum | Sweetwater, Tex. |
| The Telegram | Bucyrus, Ohio |
| Leader Republican Herald | Herkimer, N. Y. |
| Garrett Newspaper | Gloversville, N. Y. |
| North Manchester Newspaper | Garrett, Ind. |
| The Telegram | North Manchester, Ind. |
| Eureka Newspaper | Rocky Mount, N. C. |
| Cowpens | Eureka, S. Dak. |
| The Herald | Cowpens, S. C. |
| The Herald | Williston, N. Dak. |
| Carlton Newspaper | Morris, Ill. |
| | Carlton, Minn. |

| | |
|-----------------------|---------------------|
| The Call | Lead, S. D. |
| Mexico Ledger | Mexico, Mo. |
| Inverness Newspaper | Inverness, Dla. |
| The Dispatch | Oneida, N. Y. |
| The Times | Florence, Ala. |
| Carlinville Newspaper | Carlinville, Ill. |
| The Republican | Millville, N. J. |
| Recorder & Democrat | Amsterdam, N. Y. |
| The Tribune | Great Bend, Kansas |
| News Telegraph | Atlantic, Ia. |
| The Herald | Sapulpa, Okla. |
| The Sentinel | Woodstock, Ill. |
| Denison Newspaper | Denison, Ia. |
| The Enterprise | Paris, Ky. |
| Laurium Newspaper | Laurium, Mich. |
| The Tribune | New Albany, Ind. |
| Gillespie Newspaper | Gillespie, Ill. |
| Prestonburg " | Prestonburg, Ky. |
| Union Sun & Journal | Lockport, N. Y. |
| News Banner | Bluffton, Ind. |
| The Sun | Beatrice, Nebr. |
| The Bulletin | North Platte, Nebr. |
| Express & News | Kirksville, Mo. |
| Pleasantville, N. J. | Newspaper |
| Newton, Ia. | News |
| Lexington, Nebr. | Newspaper |
| Ilion, N. Y. | " |
| Paris News | Paris, Texas |

COLUSA REMEDY CO.

Colusa Natural Oil * Colusa Natural Oil Capsules *

Colusa Natural Oil Ointment

. . General Offices . .

1507 North Wilcox Ave.

Los Angeles 28 California

April 7, 1947

Newspaper Publisher:

Re: mat for Colusa advertisement:

For the reason the word "acne" was left off our labels, please delete the word "acne" in the 4th line of the reverse heading of the 2-col X 16" adv. mat sent by Tharsing Adv. Agency, obliging,

Yours truly

Colusa Remedy Co.

Case No. 19575 Crim. U. S. A. vs. Chester W. Colgrave. Dft. Exhibit B. Date 12-19-47. Exhibit B in Evidence. Clerk, U. S. District Court, Sou. Dist of Calif. John A. Childress, Deputy Clerk. [33]

[Minutes: Monday, January 5, 1948]

Present: The Honorable Wm. C. Mathes, District Judge.

For hearing Prob. Officer's report and sentence of each defendant on counts 1 to 8 incl.; T. G. Klinger, Ass't U. S. Att'y, appearing as counsel for Gov't; E. T. McGann, Esq., appearing as counsel for defendant;

Pre-sentence memo. of defendant is filed and Prob. Officer's report and attached papers are ordered filed; Attorney Klinger states plaintiff's recommendations for sentence; defendant makes a statement; the Court pronounces judgments as follows:

District Court of the United States for the

Southern District of California

Central Division

No. 19575-Crim.

UNITED STATES OF AMERICA

v.

COLUSA REMEDY COMPANY, a Nevada corpora-
tion

JUDGMENT

[21 U. S. C. §332(b); 28 U. S. C. §387]

On this 5th day of January, 1948 came the attorney for the government and the defendant appeared through its president, Chester Walker Colgrove, and with its attorney, Eugene T. McGann, Esquire.

It Is Adjudged that the defendant has been convicted upon its plea of not guilty, after trial by the Court without a jury, a jury trial having been waived by the defendant, of the offenses of on or about April 1, 1947, May 6, 1947, July 9, 1947, April 17, 1947, April 5, 1947, May 3, 1947, April 28, 1947 and April 2, 1947, having shipped in interstate commerce a product which failed to bear specific directions for use of the product in the treatment of all ills, conditions and diseases for which the product is prescribed or recommended or suggested in the advertising material disseminated and sponsored by the defendant and Chester Walker Colgrove; and in disregard of the injunctions issued February 24, 1947 and April 23, 1947 by this Court in cause numbered 5992-WM Civil, as charged in Counts One to Eight inclusive of the information; and the Court having asked the defendant

whether it has anything to say why judgment should not be pronounced, and no sufficient cause to the contrary being shown or appearing to the Court,

It Is Adjudged that the defendant is guilty as charged and convicted.

It Is Adjudged that the defendant pay to the United States of America a fine of \$500 for the offense charged in Count One of the information; a fine of \$500 for the offense charged in Count Two of the information; a fine of \$500 for the offense charged in Count Three of the information; a fine of \$1,000 for the offense charged in Count Four of the information; a fine of \$500 for the offense charged in Count Five of the information; a fine of \$1,000 for the offense charged in Count Six of the information; a fine of \$500 for the offense charged in Count Seven of the information; and a fine of \$500 for the offense charged in Count Eight of the information; and that the total fines aggregating \$5,000 shall be paid on or before January 10, 1949.

It Is Further Adjudged that the defendant be permitted to pay the fines herein imposed in monthly installments of \$200 or more each month, commencing January 10, 1948, provided that the defendant pay the full sum of \$5,000 on or before January 10, 1949.

It Is Adjudged that the defendant is not guilty on Count Nine of the information in accordance with the finding of the Court on the trial on December 19, 1947.

WM. C. MATHES

United States District Judge

Filed January 5, 1948. Edmund L. Smith, Clerk; by Louis J. Somers, Deputy Clerk. [35]

District Court of the United States for the
Southern District of California
Central Division
No. 19575-Crim.

UNITED STATES OF AMERICA

v.

CHESTER WALKER COLGROVE

JUDGMENT AND PROBATIONARY ORDER

[21 U. S. C. §332(b); 28 U. S. C. §387]

On this 5th day of January, 1948 came the attorney for the government and the defendant appeared in person and with his attorney, Eugene T. McGann, Esquire.

It Is Adjudged that the defendant has been convicted upon his plea of not guilty, after trial by the Court without a jury, jury trial having been waived by the defendant, of the offenses of on or about April 1, 1947, May 6, 1947, July 9, 1947, April 17, 1947, April 5, 1947, May 3, 1947, April 28, 1947 and April 2, 1947, having shipped in interstate commerce a product which failed to bear specific directions for use of the product in the treatment of all ills, conditions and diseases for which the product is prescribed or recommended or suggested in the advertising material disseminated and sponsored by the defendant and Colusa Remedy Company, a Nevada corporation; and in disregard of the injunctions issued February 24, 1947 and April 23, 1947 by this Court in cause numbered 5992-WM Civil, as charged in Counts One to Eight inclusive of the information; and the Court having asked the defendant whether he has anything to say why judgment should not be pronounced, and no sufficient

cause to the contrary being shown or appearing to the Court,

It Is Adjudged that the defendant is guilty as charged and convicted.

It Is Adjudged that the defendant is hereby committed to the custody of the Attorney General or his authorized representative for imprisonment for a period of six months in a jail-type institution to be selected by the Attorney General of the United States or his authorized representative for the offense charged in Count One of the information; and be further imprisoned for a like period of six months for the offense charged in Count Two of the information; and be further imprisoned for a like period of six months for the offense charged in Count Four of the information; and be further imprisoned for a like period of six months for the offense charged in Count Six of the information; that all terms of imprisonment imposed under Counts One, Two, Four and Six shall commence and run Consecutively.

It Is Further Adjudged that the defendant pay to the United States of America a fine of \$1,000 for the offense charged in Count Three of the information; a like fine of \$1,000 for the offense charged in Count Five of the information; a like fine of \$1,000 for the offense charged in Count Seven of the information; and a like fine of \$1,000 for the offense charged in Count Eight of the information; and be further imprisoned until all said fines be paid or until the defendant is otherwise discharged as provided by law.

It Is Further Adjudged that execution of all sentences herein imposed for the offenses charged in Counts One, Two, Three, Four, Five, Six, Seven and Eight be and is

hereby suspended, and the defendant is placed on probation for the period of five years commencing forthwith; and the conditions of probation are fixed as follows: during the probationary period the defendant shall (1) pay to the United States of America the fines, aggregating \$4,000 imposed for the offenses charged in Counts Three, Five, Seven and Eight of the information, said fines to be paid at such times and in such installments as the Probation Officer of this Court shall direct; (2) obey all laws applicable to the defendant's conduct wherever he may be; and (3) comply with all rules which the Probation Officer of this Court may prescribe for the guidance of his personal conduct.

It Is Further Adjudged that the probationary periods and the conditions of probation shall be the same as to Counts One, Two, Three, Four, Five, Six, Seven and Eight; that the probationary periods shall commence and run concurrently; that compliance with the conditions of probation as to Count One shall also constitute compliance with the conditions of probation as to the remaining counts; and that a violation of any of the conditions of probation as to Count One shall likewise constitute a violation of the conditions as to the remaining counts.

It Is Adjudged that the defendant is not guilty on Count Nine of the information in accordance with the finding of the Court on the trial on December 19, 1947.

WM. C. MATHES

United States District Judge

Filed January 5, 1948. Edmund L. Smith, Clerk; by Louis J. Somers, Deputy Clerk. [36]

[Title of District Court and Cause]

NOTICE OF APPEAL

Name and Address of Appellants:

Chester Walker Colgrove, 1507 N. Wilcox, Los Angeles 28, California;

Colusa Remedy Company, 1507 N. Wilcox, Los Angeles 28, California;

Colusa Remedy Company, a Nevada Corporation, 1507 N. Wilcox, Los Angeles 28, California.

Name and Address of Appellants' Attorney:

Morris Lavine, 620 Bartlett Building, 215 West Seventh Street, Los Angeles 14, California.

Offenses:

Criminal contempt of court as to first 8 counts for alleged violation of the court's orders of February 26, 1947 and April 23, 1947. (21 U. S. C. A., Section 332(b) and 28 U. S. C. A., Section 387.) [38]

Date of Judgments:

January 5, 1948.

Brief Description of Judgments and Sentences:

Chester Walker Colgrove, sentenced to serve six months in jail on Counts One, Two, Four and Six of the information, to run consecutively, or a total of two years in a jail type of institution, suspended for a period of five years. A fine of \$1,000.00 as to counts three, five, seven and eight, or a total fine of \$4,000.00 and to be imprisoned until said fine is paid.

A fine of \$5,000.00 on Colusa Remedy Company, a Nevada Corporation, or a total fine of \$9,000.00.

Name of Prison Where Now Confined, if Not on Bail:

None.

We, the above appellants, hereby appeal to the United States Circuit Court of Appeals for the Ninth Circuit from the judgments and each of them above named.

Dated: January 12, 1948.

MORRIS LAVINE

Attorney for Appellants

CHESTER WALKER COLGROVE

CHESTER WALKER COLGROVE,

trading and doing business under the firm name of COLUSA REMEDY COMPANY and COLUSA REMEDY COMPANY, a Nevada Corp.

By Chester Walker Colgrove

President [39]

Received copy of the within Notice of Appeal this 13th day of January, 1948. James M. Carter, U. S. Atty.; by Gertrude M. Johnson.

[Endorsed]: Filed Jan. 13, 1948. Edmund L. Smith, Clerk. [40]

[Minutes: Monday, January 19, 1948]

Present: The Honorable Wm. C. Mathes, District Judge.

Morris Lavine, Esq., appearing as counsel for defendant, now comes before the Court and make a statement that appeal notice has been filed and moves that \$200 cashier's check tendered as payment of fine be deposited in the registry of the Court to abide the final outcome of the case, and it is so ordered. [41]

In the United States Circuit Court of Appeals
for the Ninth Circuit
(Undocketed)

UNITED STATES OF AMERICA,

Plaintiff-Appellee,

vs.

CHESTER WALKER COLGROVE, trading and doing
business under the firm name of COLUSA REMEDY
COMPANY and COLUSA REMEDY COMPANY,
a Nevada corporation,

Defendants-Appellants.

PETITION FOR ORDER FOR EXTENSION OF
TIME TO FILE RECORD AND DOCKET AP-
PEAL

Come now defendants-appellants above named, by their
attorney, Morris Lavine, and petition this Honorable
Court for an order extending the time to file the record
on appeal herein and docket the appeal to and including
March 13, 1948. This application is based on the affidavit
of Morris Lavine, attached hereto.

Ray vs. U. S., 301 U. S. 158.

MORRIS LAVINE
Attorney for Defendants-Appellants

ORDER EXTENDING TIME TO FILE RECORD
ON APPEAL AND DOCKET APPEAL

Good Cause Appearing, It Is Ordered that the time for filing the record and docketing the appeal herein be, and it hereby is, extended to and including March 13, 1948.

Dated: San Francisco, California, February 20, 1948.

FRANCIS A. GARRECHT
U. S. Circuit Judge

[Title of Circuit Court of Appeals and Cause]
(Undocketed)

AFFIDAVIT IN SUPPORT OF PETITION FOR
EXTENSION OF TIME TO FILE RECORD
AND DOCKET APPEAL

State of California

County of Los Angeles—ss:

Morris Lavine, being first duly sworn, deposes and says: That he is the attorney for appellants in the above-entitled cause; that this cause involves an appeal from an order of the District Court for contempt, relating to pure foods and drugs; that the record on appeal is due to be filed in San Francisco on February 21, 1948.

That there appears to be some confusion and some unnecessary matters in the proposed record, which would make the same very bulky and it is the desire of affiant to eliminate the unnecessary matters from the record on appeal; that affiant has talked to Deputy United States Attorney Klinger with the view to arranging such con-

densation of the record, and that additional time is necessary for the completion of the details thereof; that three weeks' additional time from February 21, 1948, is desired for completing the record on appeal.

Wherefore, affiant prays that this Honorable Court enlarge the time within which to file the record and docket the appeal in the Circuit Court of Appeals to and including March 13, 1948.

MORRIS LAVINE
Attorney for Defendants-Appellants

Subscribed and sworn to before me this 18th day of February, 1948.

MILTON B. SAFIER

Notary Public in and for the County of Los Angeles,
State of California

A True Copy. Attest: Feb. 20, 1948. Paul P. O'Brien,
Clerk.

[Endorsed]: Filed Feb. 20, 1948. Paul P. O'Brien,
Clerk.

[Endorsed]: Filed Feb. 24, 1948. Edmund L. Smith,
Clerk.

[Title of District Court and Cause]

CERTIFICATE OF CLERK

I, Edmund L. Smith, Clerk of the District Court of the United States for the Southern District of California, do hereby certify that the foregoing pages numbered from 1 to 26, inclusive, contain full, true and correct copies of Information re Contempt; Order to Show Cause re Criminal Contempt; Minute Order Entered December 8, 1947; Plaintiff's Exhibits 1, 2, 3 and 4; Waiver of Trial by Jury and Waiver of Special Findings of Fact; Defendants' Exhibits A and B; Minute Order Entered December 19, 1947; Minute Order Entered January 5, 1948; Judgments and Commitments; Notice of Appeal; Minute Order Entered January 19, 1948; Praecipe; Counter-Designation of Record and Notice to Prepare Record on Appeal which, together with copy of Reporter's Transcript of proceedings on December 8 and 19, 1947, transmitted herewith, constitute the record on appeal, to the United States Circuit Court of Appeals for the Ninth Circuit.

I further certify that my fees for preparing, comparing, correcting and certifying the foregoing record amount to \$14.00 which sum has been paid to me by appellants.

Witness my hand and the seal of said District Court this 11 day of March, A. D. 1948.

(Seal)

EDMUND L. SMITH

Clerk

By Theodore Hocke
Chief Deputy

[Title of District Court and Cause]

Honorable William C. Mathes, Judge Presiding

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Los Angeles, California, Monday, December 8, 1947
Appearances:

For the Plaintiff: James M. Carter, United States Attorney; by T. B. Klinger, Esquire, Asst. United States Attorney.

For the Defendants: Eugene T. McGann, Esquire.

Los Angeles, California, Monday, December 8, 1947
1:30 P. M.

(Case called by the clerk.)

Mr. Klinger: Ready for the government, your Honor.

Mr. McCann: Ready for the defendants.

The Court: How long do you estimate that matter will take, gentlemen?

Mr. Klinger: We think it will be very brief in the light of the stipulation which we have prepared to be submitted this afternoon to your Honor; at least, I think the Government's case is entirely covered by the stipulation. There will be some argument on the law, perhaps, that your Honor may wish to hear this afternoon.

The Court: Is this a proceeding triable by a jury under Section 387?

Mr. Klinger: If a jury is demanded, I understand that a jury would be required under that Section to which your Honor referred, and it so states.

This proceeding today, of course, is on the return to the order to show cause and, as I read the section

to which the Food and Drug Section refers, it declares that after that, at this hearing, reading from Section 387 of Title 28:

“If upon or by such return, in the judgment of the court, the alleged contempt be not sufficiently purged, a trial shall be directed at a time and place fixed by the court.” [2*]

And while I have not been through this procedure before, I would assume that under that, today's proceeding is preliminary to such a trial, if one is to be had, although I think that the trial will be obviated in any event by the stipulation that we have.

The Court: Do you have the specific stipulation?

Mr. Klinger: May I say for the record, your Honor, that I hold in my hand a stipulation which has been entered into and signed between the parties to this proceeding which I should like to submit at this time. In doing so there are three exhibits which must be submitted together with the stipulation. The stipulation is very brief and I will read it so that we can understand where we stand at the moment.

“It is hereby stipulated and agreed by and between the parties to this criminal contempt action:

“(1) That all of the facts set forth in the Criminal Information are true, except that it is not admitted that the advertisements referred to in said Information prescribe, recommend and suggest Colusa Natural Oil in the treatment of poison ivy, poison oak, bed sores, acne, ringworm, scaly red face, burns, piles, and itch.

*Page number appearing at top of page of original Reporter's Transcript.

"(2) That the attached newspaper advertisement taken from page 8 of the June 12, 1947, issue of The [3] Ridgewood Herald-News, Ridgewood, New Jersey, and identified as Exhibit A, is typical of the advertisements referred to in said Information.

"(3) That the label on the bottle of Colusa Natural Oil identified as Exhibit B is representative of the labels referred to in Counts 1-8 of the Information.

"(4) That the label on the bottle of Colusa Natural Oil identified as Exhibit C is representative of the labels referred to in Count 9 of the Information.

"Dated: This 8th day of December, 1947." And then the signatures follow.

The advertisement referred to in paragraph (2) of the stipulation is the one which I hold in my hand, and I ask the clerk to mark this as Exhibit A and offer it into evidence pursuant to this stipulation.

The Court: Is there objection?

Mr. McGann: No objection.

The Court: Very well; it will be received and marked Government's Exhibit or Plaintiff's Exhibit 1, Mr. Clerk.

The Clerk: So marked, your Honor.

The Court: Exhibit 1 upon the hearing on the return to the order to show cause. That is an advertisement that appeared where? [4]

Mr. Klinger: It appeared in the June 12, 1947, issue of The Ridgewood Herald-News, of Ridgewood, New Jersey.

The Court: Is that the type of advertisement referred to in Count One?

Mr. Klinger: Yes, your Honor; the type of advertisement referred to in all of the counts of the information wherever an advertisement is referred to; and I believe it appears in the first eight counts—all nine counts, the same advertisement is involved.

I now hold in my hand a bottle bearing the label "Colusa Natural Oil," and this is the label on the bottle referred to in paragraph (3) of the stipulation which I have just read. It is identified in the stipulation as "Exhibit B," and this label is representative of labels referred to in Counts One through Eight of the information.

The Court: Is that the label quoted?

Mr. Klinger: That is the label quoted.

The Court: In part, at least.

Mr. Klinger: In part in Count One on page 2 of the information. And at this time, pursuant to the stipulation, I offer this label affixed to this bottle in evidence as the Government's exhibit next in order.

The Court: Is there objection?

Mr. McGann: No objection.

The Court: The label is received into evidence along [5] with the bottle. Do you offer the contents, too?

Mr. Klinger: The contents are not offered, your Honor, but the label.

The Court: Only the label.

Mr. Klinger: Only the label is in issue.

The Court: Very well; the label is received into evidence and will be marked Plaintiff's Exhibit 2 on the return to the order to show cause.

Mr. Klinger: And I now hold in my hand another bottle labeled "Colusa Natural Oil" which is referred to in paragraph (4) of the stipulation, and there referred to as "Exhibit C"; and this label is representative of the

labels referred to only in Count Nine of the information. And, pursuant to the stipulation, the Government offers this label into evidence as the Government's exhibit next in order.

The Court: Is there objection?

Mr. McGann: No objection.

The Court: Very well; it will be received and marked Plaintiff's Exhibit 3 upon the return to the order to show cause.

Mr. Klinger: The Government has no additional evidence to offer and is prepared to—

The Court: Did you file the stipulation?

Mr. Klinger: The stipulation has not been given to the [6] clerk.

The Clerk. Shall the stipulation be marked as an exhibit?

The Court: Yes; let it be marked as Plaintiff's Exhibit 4.

Does the defendant deny that this is a violation of the statute?

Mr. McGann: To this extent, your Honor: The defendant, immediately upon the service on him of the injunction, changed the labels so that they would adequately meet the requirements of the injunctive order. The labels were changed, the word "Acne" being deleted from them, and the advertisements were so changed.

Now, there is one of these—

The Court: Is there any evidence of that here?

Mr. McGann: What is it?

The Court: Is there any evidence of that here?

Mr. McGann: Why, yes; the label itself would show that. You have two labels there. There is one of these labels. I believe, was a shipment that was in interstate

commerce or interstate traffic at the time that this order was made and it was ordered returned for re-labeling. It was shipped on the 2nd of October, 1946 and it was returned here under date of June the 18, 1947.

I believe these two labels will differ somewhat. The [7] one that is to be used in Counts One to Eight is the one that has been changed to conform with your order.

The Court: And it is the defendants' contention that the label that is referred to in Count Nine—

Mr. McGann: In Count Nine.

The Court: —which is here attached to the bottle, Plaintiff's Exhibit 2—

Mr. Klinger: Exhibit 3, your Honor, that would be.

The Court: —Exhibit 3, that label does not refer to any disease, does it?

Mr. McGann: And that was the one that was in interstate traffic at the time that the order was made.

The Court: Which is the label, now, that you say complies?

Mr. McGann: The label is the one now that shows it was to treat certain diseases.

The Court: Is that the one that reads: "A natural unrefined petroleum oil intended for use in treatment of Psoriasis, Eczema, Athlete's Foot and Leg Ulcers."?

Mr. McGann: That is right.

The Court: Does the Government agree that this now complies?

Mr. Klinger: No. Of course, your Honor, the first eight counts are based on that label and say that that label does not comply with the order because the advertising [8] which is disseminated in connection with this product bearing that label recommends, suggests, and pre-

scribes that product for those other nine conditions referred to in the information.

The Court: Let me get the labels straight now. This bottle here, Exhibit 3, and the label, that contains no reference to any disease at all; that is the old label?

Mr. Klinger: That is the old label and it is only referred to in Count Nine of the information.

The Court: Then I was mistaken. That is the one referred to in Count Nine only?

Mr. Klinger: Only, yes, sir; that is correct.

The Court: And the new label or the lengthier—

Mr. Klinger: That is correct.

The Court: —contains more printed matter and refers to the diseases, I suppose, namely, Psoriasis, Eczema, Athlete's Foot and Leg Ulcers, Plaintiff's Exhibit 2, is the new label that is referred to in the first eight counts, is that correct?

Mr. Klinger: That is corrrect, your Honor.

The Court: The defendant contends that the new label purges the defendant of any contempt?

Mr. McGann: Well, I can't see how he could be in contempt when he is doing everything possible to conform to the order. [9]

The Court: The Government's position, I take it, is that this advertising material, which I take it is admittedly put out by the defendant—?

Mr. McGann: It is admitted it is put out by the defendant. He deleted the word "Acne" from the type of advertisement. The old type of advertising read: "Psoriasis, Athlete's Foot, Acne, Eczema, Leg Ulcers." He did not have "Acne" on the label so he deleted it from the advertising.

The Court: Well, this advertisement says: "SKIN SUFFERERS read how simple use of a product from the earth quickly released hundreds from misery of PSORIASIS—ATHLETES FOOT—and" an arrow that points down to the remainder.

Mr. McGann: "ECZEMA" and "LEG ULCERS."

The Court: Then comes "ECZEMA—LEG ULCERS" and "SUMMARY OF CLINICAL REPORTS ON 28 CASES" which includes psoriasis, eczema, athletes foot, poison ivy or oak, and then follows "Thousands of DOCTORS Are COLUSA Customers Excerpts from a few of their reports." Then follows reports on eczema, poison ivy, athletes foot, leg ulcers, eczema, acne, ring-worm. Then "EXCERPTS FROM REPORTS BY DRUGGISTS," and finally, "Thousands of USERS WRITE LETTERS of PRAISE."

Following all that "WE SELL ONLY TO DRUGGISTS AND DOCTORS.

"Try Colusa Natural Oil and Capsules on liberal money- [10] back guaranty. They may do the wonders for you they have for thousands of others."

What is your point about the advertisements, again?

Mr. McGann: I did not hear your Honor.

The Court: Do you contend that the advertisement does not recommend these Colusa remedies for those diseases?

Mr. McGann: Well, I would say that he was merely publishing these testimonials as they were presented to him. I do not believe it was his intent to prescribe or suggest their use for those purposes.

The Court; Why would he pay the money to publish them?

Is it the Government's contention that this advertisement becomes in effect a part of the label?

Mr. Klinger: Not necessarily a part of the label, your Honor, no; but it is in conflict with the court's order heretofore entered, which is, pursuant to the statute, that the defendants are not in their advertising, after those injunctions, to recommend, suggest or prescribe this product for any conditions, any of the disease conditions other than those named on the label.

The Court: The injunction was from "introducing or delivering for introduction into interstate commerce, in any form or manner, the product known as Colusa Natural Oil, or any like product, without a label containing specific [11] directions for the use of such product in the treatment of all conditions, ills and diseases for which such product is prescribed, recommended, and suggested, in the advertising material disseminated or sponsored by or on behalf of the defendants or either of them; * * *"

There is no question but this advertisement is sponsored by the defendant?

Mr. McGann: The advertisement is sponsored by the defendant and paid for by the defendant.

The Court: Is it still being used, that type of advertisement? There is no showing it is not still being used. I assume it is and the label is.

I find that the alleged contempt has not been sufficiently purged. I will hold the defendant for trial.

Do the defendants wish a jury trial?

Mr. McGann: Just a moment. I shall have to ask. No; a court trial will be satisfactory.

The Court: When would you wish to have the matter heard?

Mr. Klinger: Any day next week, your Honor, will be satisfactory with the Government.

Mr. McGann: I have to be in court on the 16th on another matter.

The Court: Would any day other than the 16th be convenient to you, Mr. McGann? [12]

Mr. McGann: Any day other than the 16th; that is right.

The Court: How would Friday morning, the 19th, be?

Mr. McGann: Satisfactory.

Mr. Klinger: Satisfactory with the Government, your Honor.

The Court: Is Mr. Chester Walker Colgrove in court? (The defendant Colgrove comes forward.)

The Court: You are here, are you, Mr. Colgrove—

Defendant Colgrove: Yes, sir.

The Court: —on behalf of the defendant, the Colusa Remedy Company?

Defendant Colgrove: I am, sir.

The Court: A Nevada corporation; and on behalf of yourself, of course?

Defendant Colgrove: Yes, sir.

The Court: You have heard Mr. McGann's statement that you waive a jury trial in this matter?

Defendant Colgrove: I do.

The Court: Is Friday, the 19th, at 10:00 o'clock satisfactory to you?

Defendant Colgrove: I would suggest, your Honor, that you try it right now.

The Court: I have several other matters on the calendar this afternoon, Mr. Colgrove, and I would like an [13] opportunity to study this evidence that has been presented, before proceeding here. If that is agreeable

with you, I will set it for the 19th of December at 10:00 o'clock.

Defendant Colgrove: Thank you.

The Court: Very well.

Mr. Klinger: Your Honor, is it the understanding that the stipulation that has heretofore been filed—I think that will be agreeable—will continue for the purposes of the trial set on Friday; that it will remain in effect and will represent the stipulation of the parties at that time as well as at this hearing?

The Court: I assume that what has been offered and received here, the exhibits, including the stipulation, represents the return to this order to show cause and may be deemed in evidence upon the trial; is that right?

Mr. McGann: Yes, your Honor.

Mr. Klinger: Your Honor, may I submit a very brief memorandum of less than four pages, just touching upon some of the high-lights and mentioning some of the law which we believe applies to the instant case?

The Court: You may serve it and file it.

Mr. Klinger: Thank you, your Honor.

The Court: Very well, gentlemen. The evidence introduced here this afternoon will be part of the evidence upon the trial now set for December 19th at 10:00 o'clock. [14]

Mr. Klinger: That you, your Honor. [15]

Los Angeles, California, Friday, December 19, 1947
10:00 A. M.

(Case called by the clerk and announced ready by respective counsel.)

The Court: Is Mr. Colgrove in court?

Mr. McGann: He is in court, your Honor.

The Court: I believe it was stipulated at the time of

the return and hearing upon the order to show cause that the matters then introduced into evidence would be deemed a part of the record upon this trial?

Mr. McGann: That is right.

Mr. Klinger: That was my understanding, your Honor, including the stipulation, of course, pursuant to which those items of evidence were introduced.

The Court: Oh, yes. You may proceed for the Government.

Mr. Klinger: Your Honor, the Government rests upon that stipulation and the evidence which was introduced into evidence pursuant to that stipulation. The Government has no further evidence to offer.

The Court: The defendants?

Mr. McGann: I guess I will have to put the defendant on the stand, if the court please.

The Court: Very well.

Mr. McGann: Take the stand, Mr. Colgrove. [2]

CHESTER WALKER COLGROVE,
a defendant herein, being first sworn, was examined and testified as follows:

The Clerk: What is your name, please?

The Witness: Chester Walker Colgrove.

Direct Examination

By Mr. McGann:

Q. Mr. Colgrove, you are doing business as the Colusa Remedy Company?

A. I am president of that company; yes, sir.

Q. A Nevada corporation?

A. Yes, sir.

Q. In Count Nine of the information here, Mr. Colgrove, it is alleged that you caused to be shipped from

(Testimony of Chester Walker Colgrove)

Philadelphia, Pennsylvania, consigned to Colusa Remedy Company, of Los Angeles, California, a certain quantity of the drug "Colusa Natural Oil." Will you state to the court the circumstances of that shipment and how and why you entered into that to have that shipped?

A. The shipment consisted of 16 cartons of Colusa Natural Oil in capsules. The shipment was introduced into interstate commerce on October 2nd, 1946, about 40 days prior to the filing of the suit brought by the Government resulting in the decree of injunction. [3]

The shipment was made on October 2nd by delivery to the Railway Express Company, shipped by Colusa Remedy Company to C. W. Colgrove, myself, at Philadelphia. It was made in anticipation of a certain advertising program which did not materialize. The shipment remained in the possession of the Railway Express Company at Philadelphia until in June, 1946—1947, at which time I ordered its return to be re-labeled, and within that same week I shipped an equivalent or an approximately equivalent of merchandise, both shipments amounting to nearly \$5,000 net value, to the same Philadelphia customer for which the original shipment to myself had been intended, with the new labels attached.

So that that shipment, introduced by delivery to a common carrier on October 2nd, 1946, remained in the possession of that same common carrier, without delivery in the meantime to anyone, until in June, 1947, when it was seized under a libel proceeding and, as of December 5, 1947, about two weeks ago, I am informed it is still in the possession of that same common carrier.

I ordered it returned for re-labeling in order to put the labels on to conform with the decree of injunction.

(Testimony of Chester Walker Colgrove)

The Court: That re-shipment you made to the Philadelphia customers, is that involved in any of these charges?

The Witness: No, sir. [4]

The Court: That was not interfered with?

The Witness: No, sir; not in this proceeding. It was subsequently. Some was subsequently seized in another proceeding, another libel proceeding?

The Court: In this court?

The Witness: No.

Q. By Mr. McGann: Mr. Colgrove, I show you a letter from the Railway Express Agency, addressed to "Colusa Remedy Co.", and ask you if that is the letter that you received from the express company?

A. It is, sir.

Q. And that is in reference to the shipment of the goods from Philadelphia?

A. That is right, sir.

Mr. McGann: If the court please, I will offer this into evidence at this time.

Mr. Klinger: No objection, your Honor.

The Court: Very well.

Mr. Klinger: This is the Defendants' first exhibit.

The Clerk: Defendants' A in evidence.

Q. By Mr. McGann: Now, in reference to the various other counts in this information wherein you are accused of shipping Colusa Natural Oil to these various organizations like the Schlitz Bros. Drug, Appleton, Wisconsin; the Crescent Drug, Walla Walla, Washington; William H. McNeill, [5] Druggist, Midland Park, New Jersey; Rands Drug, Inc., Pittsburgh, Pennsylvania; the Ballou-Latimer Drug, Boise, Idaho; and the Thrifty Drug Store in

(Testimony of Chester Walker Colgrove)

Rochester, Minnesota, wherein you are charged with shipment of the drug with a certain label, and also having sponsored certain advertising of the benefits to be derived from the use of that drug, will you explain to the court just what your position is in that matter?

A. All of those shipments were made with the new label on as shown by the Government's Exhibit B herein subsequent to the injunction decree. The advertisement introduced herein as Exhibit A for the Government—

The Court: I think you are referring to Exhibits 1 and 2.

The Witness: Oh, I beg your pardon, 1 and 2.

The Court: You are referring to the—

The Witness: The Colusa Natural Oil and the advertisement.

The Court: The new label.

The Witness: The new label.

The Court: Is Exhibit 2; and you refer to The Ridgewood Herald-News, which is Government's Exhibit 1.

The Witness: That is right; Exhibit 1.

The Court: You may proceed.

A. The advertisement, except for the lack of one [6] word "Acne" was prepared by me in March of 1944. So it had been a successful producer. But before using it in 1947, subsequent to the injunction, I studied the advertisement carefully in the light of the injunction and reached the conclusion that, in view of the fact the label did not contain the word "Acne" that I must eliminate "Acne" from the advertised diseases in the advertisement. And I had at that time about 60 mats on hand that contained the word "Acne"; so in sending them out to the newspapers, I wrote a letter to each newspaper stating to them

(Testimony of Chester Walker Colgrove)

that in view of the fact that the word "Acne" was left off of our label, kindly delete the word "Acne" from the reverse heading in the advertisement with the large type.

Q. By Mr. McGann: I will show you what purports to be a letter on the Colusa Remedy Company's stationery and ask you if that is a copy of the letter that you sent out to the newspapers?

A. That is a copy of the letter and attached to it is a list of the newspapers to which it was sent.

Q. I will show you a copy of an advertisement from the Winfield Daily Courier of Wednesday, April 16, 1947, showing the advertising with the—

A. Word "Acne" blotted out.

Q. Is that where "Acne" was, where that blank space shows next to "athletes foot"? [7]

A. Yes, sir.

Mr. McGann: At this time, if the court please, I will offer the letter and the list of the newspapers and hand up a copy of the newspaper, as the Defendants' Exhibit 2.

The Court: Do you desire it as one exhibit?

Mr. McGann: I did not hear your Honor.

The Court: Do you desire them both marked as one exhibit?

Mr. McGann: One exhibit.

The Court: Very well; it will be Defendants' Exhibit—

Mr. Klinger: Your Honor, just to avoid confusion, I raise the point with respect to the newspaper advertisement that we have already stipulated, as your Honor knows, that the advertisement heretofore introduced by the Government is typical of all. This one is slightly different. I have no basic objection to it, since it merely

(Testimony of Chester Walker Colgrove)

shows the deletion of the word "Acne," but I think, for the sake of the record, it should be clear that we have already agreed that the advertisement already in evidence is the type of advertisement which is referred to in the first eight counts of the information.

The Court: Exhibit 1 is this same copy, I take it, except the plate has been corrected?

Mr. McGann: It is different in form, is all. The word "Acne" shows to be deleted and it does not show at all [8] in the Exhibit 1.

The Court: The Exhibit 1, I suppose, is the new plate?

The Witness: That is right.

Mr. McGann: The new plate.

The Court: The exhibit you now offer is the old plate with the white spot indicating the place where the word "Acne" once appeared?

The Witness: That is right, sir.

Mr. McGann: That is right, your Honor.

The Court: I think the record will be sufficiently clear on that.

Mr. Klinger: Yes, your Honor.

The Court: The letter and advertisement will be received into evidence and marked Exhibit B.

The Clerk: B in evidence.

A. With further reference to your original question, in my analysis of the injunction decree I interpreted the language "prescribed, recommended, and suggested," to mean "prescribed, recommended, and suggested," all three, and not "prescribed, recommended, or suggested," any one of them. And in my study I went to the office dictionary and got the definition of "prescribe," which is

(Testimony of Chester Walker Colgrove)

"directions to use; with instructions as to use;" and subsequent to the filing of this action, I found the law library [9] dictionary to have the same definition.

I did not "prescribe" on the label for any of the fine-print diseases in the advertisement. I had no intention of advertising any of the diseases in the advertisement except those that were high-lighted in big type; and that arrow pointing to those pictures was the intention of the arrow, and not pointing to the entire balance of the advertisement.

Q. By Mr. McGann: Excepting for the ailment referring to Piles, of the various additional diseases that are listed by the information here as appearing in the advertisement was it your assumption that the high-lighted diseases mentioned above included such ailments as scaly face, ringworm, itch, etc.?

A. Well, itch is a very common condition incident to eczema, athlete's foot, leg ulcers or psoriasis, and bed sores or open sores, sometimes, and they are prescribed for on the new label.

Poison oak and poison ivy are commonly known as eczema forms—there are many eczemas—and just a month ago I heard them again so described by a Government expert witness. Poison ivy and poison oak are among the eczemas.

Ringworm is commonly treated as an athlete's foot of the fungi type.

"Burns" is very indefinite. I have never advertised [10] "burns"; never advertised scaly red face. I have never seen an advertisement for scaly red face, but it is a condition that is very common to eczema of the face, psoriasis of the face.

(Testimony of Chester Walker Colgrove)

As to "piles" we do not advertise for piles, and piles is referred to in these charges in connection with the ointment capsules which are not involved in these charges.

But I am frank to admit that at the time that I was analyzing the advertisement in the light of the injunction, I relied upon the common sense conclusion that I was only advertising those diseases that are in the large type; and my literal interpretation of "prescribed, recommended, and suggested," the label not carrying any specific references to those diseases and no specific references as to the instructions as to the use for those particular conditions under those names. But certainly I acted in the best of faith as far as trying to conform that advertising with the injunction decree and in every act in the conduct of the business, even to the extent of suspending all intra-state shipments as well as all interstate shipments following the decree until new labels were printed to conform with the decree, ordering back merchandise that could have been sold in the states from which it was returned without violation of the injunction, but at a cost [11] of several hundred dollars. In order to comply, in good faith, I wanted it returned and re-labeled; and that is about all there is to it.

Q. There was no intent on your part at any time to violate this injunction?

A. Positively not.

Q. You did everything you felt that was in your power towards conforming with it?

A. I did.

Mr. McGann: You may take the witness.

(Testimony of Chester Walker Colgrove)

Cross-Examination

By Mr. Klinger:

Q. Mr. Colgrove, after the injunction the only change you made in the advertising was to delete the word "Acne," is that right?

A. In that advertisement; yes, sir.

Q. And you felt after that proceeding before this court that by deleting the word "Acne" from your advertising you were complying, in good faith, with the injunction of this court?

A. I did; because I felt that before deleting the word I was advertising for the five diseases named in the heading advertisement in the large type, and that as long as "Acne" was not in the new label, I was obliged to delete it and did so. [12]

Q. But it is a fact, although deleting "Acne" from the large print, it does appear in the testimonial part of the advertisement, is that right?

A. That is true, but it is not as advertised. Those things are psychologically cumulative and supportive. They were not definitely advertised.

Q. Is it your position that the large type at the top of the advertisement constitutes "prescribing, recommending, and suggesting" but that the material which appears in the rest of the advertisement does not constitute "prescribing and suggesting"?

A. I did not prescribe for any of the material in the rest of the advertisement. That is one of your allegations.

Q. You say you were not "prescribing." Were you "recommending and suggesting" only? Is that the point?

(Testimony of Chester Walker Colgrove)

A. I was not "prescribing, recommending and suggesting." I was conforming with the decree, in my opinion, according to my literal interpretation of it.

Q. You are an attorney and a member of the bar?

A. I was graduated from the University of Minnesota law school in 1910. I have never practiced law, and about the first time that I ever visited a law library was last week, when I went down to confirm the law library dictionary definition of "prescribe." [13]

Q. Turning briefly to Count Nine, is it your testimony, then, that that particular shipment reached Philadelphia that was introduced in interstate commerce on October 2nd, 1946, consigned to you at Philadelphia?

A. That is right, sir.

Q. And it reached that destination?

A. That is right, sir.

Q. And the place to which it was consigned?

A. That is right, sir.

Q. And it remained in Philadelphia at the point of consignment until June of 1947, is that right?

A. In the possession of the same common carrier which received it when it was introduced into interstate commerce.

Q. Do you know whether or not it was in the will-call or not?

A. I do not know how they handle those things.

Q. But the destination which it reached was the destination to which it was addressed?

A. That is true. It is a very common practice to re-consign shipments.

Mr. Klinger: I do not think there is any further cross examination of the witness, your Honor.

Mr. McGann: No further examination.

The Court: You may step down, Mr. Colgrove.

Mr. Colgrove: Defendant rests. [14]

Mr. Klinger: No further evidence on the Government's part.

The Court: Argument, gentlemen?

Mr. Klinger: I do not feel that any argument is hardly necessary, and I would like to make this brief summary statement, without going into detail. I know that your Honor is familiar with it and has had an opportunity to study the file and has heard the matter without a jury.

It does appear to the Government that it was a plain and deliberate violation of the injunction. According to Mr. Colgrove's own testimony, this was an advertisement prepared in March of 1944 and had been a lucrative producer.

The court, this very court, after rather an extensive trial, handed down a preliminary decree and subsequently a permanent decree prohibiting the defendants here, both the corporation and Mr. Colgrove, from introducing into interstate commerce in any form or manner the product known as Colusa Natural Oil, or any like product, without a label containing specific directions for the use of such product in the treatment of all conditions, ills and diseases for which such product is prescribed, recommended and suggested, in the advertising material disseminated or sponsored by or on behalf of the defendants or either of them.

I believe the preliminary injunction contained the [15] words "specific directions," and I think the permanent injunction contained the words "adequate directions." With that one minor distinction, the decrees are the same.

Mr. Colgrove would have the court believe that in compliance with that injunction was to delete the word "Acne" from the advertising and, I might say, only from the big print in the advertising.

Of course, as the evidence shows, it has not been deleted—even that word or disease condition has not been deleted entirely.

The scope and magnitude of the advertising campaign which was conducted subsequent to the injunction—both injunctions—is indicated somewhat by the charges in the information, which are merely allegations of the shipments which were made. But is emphasized by the defendants' exhibit listing the newspapers in which this advertisement appears; and your Honor will see that that goes from coast to coast and from border to border.

The Court: What do you say as to Count Nine?

Mr. Klinger: As to Count Nine: It is not the important count in this information from the Government's point of view. The gravamen of the offense is actually in the first eight counts. The Count Nine represents a violation in that it is a shipment in interstate commerce of this drug improperly labeled. [16]

The contention apparently is or the suggestion is that the drug actually never left interstate commerce; that it was constantly in the stream of interstate commerce and never got out of it, and was ordered returned. However, we feel that as to that, at least certainly the cartons or the 16 cartons, under the cases, certainly came to rest in Philadelphia, where it remained for more than seven or eight months; that it reached its destination at the point to which it had been consigned.

We place no particular stress; we say, in all candor to the court, that we are not particularly interested in Count

Nine. We do feel that there is some mitigation with respect to Count Nine. We have no evidence to the contrary—to the contrary of Mr. Colgrove's testimony that his intention in calling the drug back was to have it relabeled with the new label. But we feel that at least from a purely legal point of view there is a violation of the injunction. That is in substance our position on that count.

It is the first eight counts with which we are concerned and which we do feel represent a plain violation of both injunctions.

The Court: The injunction, that is, the portion quoted in the information in Count One, is the preliminary injunction. [17]

Mr. Klinger: Yes.

The Court: It restrains the introduction of the Oil into interstate commerce without a label containing directions for treatment of the ills for which such product is "prescribed, recommended, and suggested, in the advertising material disseminated."

You have heard the defendant say that he interpreted the conjunction "and" to have the effect of making the verbs "suggested, prescribed," also "recommended," or that that use of the conjunction "and" meant to him that the product would have to be prescribed in his advertising and recommended and suggested in order to violate the injunction; and it was merely suggested, but not prescribed and recommended or, I take it, if it was prescribed, "prescribed" probably includes both recommended and suggested. But at least, as I gather from his testimony, he believes that mere suggestion is not a violation, but it would have to be more.

Mr. Klinger: Well, your Honor, we, of course, differ fundamentally from that point of view. From the Government's point of view and any common sense interpretation of this injunction, we are fully aware that injunctions are not to be expanded and to be given an interpretation going beyond their terms; but, at the same time, it is equally well established that they are not, by interpretation, to be reduced to some absurdity and in effect to a nullity, either. [18] To say what the defendant says, in substance, is that he could put on the advertising everything which he had before and everything which he has now, and then have a legend on it which says "we recommend and suggest this product for all of these disease conditions, though we do not prescribe it;" or he could say, "We prescribe and recommend this product for all disease conditions listed herein, but we do not suggest it," and that he is then complying with the injunction.

To the Government that would make the injunction meaningless. To give it a common sense, ordinary interpretation, giving the words the meaning which they ordinarily connote, it appears to us, in substance, that what this advertising says is something like the following: "If you suffer from any of the diseases mentioned in this advertisement, we urge you to try Colusa Natural Oil. It has helped thousands, as indicated by this mere sample of excerpts from clinical staffs and reports from doctors, druggists, and satisfied users. We are so sure Colusa Natural Oil will help you, too, if you suffer from any of these diseases, that we are prepared to give you your money back if it does not."

The ordinary meaning of the words "prescribe, recommend, and suggest" are fully carried out by the language in the format of the advertisement in evidence. And the

Circuit [19] Court of Appeals for this Circuit, in the case of United States v. Fulton Co., 33 F. R. (2d), page 506, says, in a related connection—I think it is fully pertinent here—that “Couched in such language undoubtedly the printed matter makes a more persuasive appeal to the credulity of sufferers from these diseases than if the representations thus implied were made directly upon the authority alone of the proprietors, and for that reason they are not less, but more, obnoxious to the law.”

And this is simply a studied and deliberate attempt to circumvent and evade what to us appears to be a very plain and direct injunction of this court.

Mr. McGann: If the court please, Mr. Colgrove would not have this court believe that he deleted the word “Acne” from the advertising for the reasons stated by the United States Attorney; but it was because of the fact that he had not put the word “Acne” on the label as one of the high-light ailments that the oil was to be used for.

Now, as to the various diseases listed in the advertising as where it was used, physicians and druggists, where they stated that they had used it for certain conditions such as poison ivy and poison oak, which you will note that the United States Attorney has listed separately, when it is common knowledge that poison ivy and poison oak are the same ailment—you get it from the [20] same source if you get it at all—I believe they call it poison sumac, and it brings about a condition that is popularly known as eczema. We know that ringworm and athlete’s foot are listed in the same category. We know that from eczema you can derive a very undesirable itch; and eczema may come from a burn, from sunburn, any chronic condition, or it may be more of an acute condition of eczema that comes from these various elements.

The average physician will not attempt to tell you what causes eczema because he knows of so many causes.

Now, in listing these various open sores—and a bed sore may be an open sore—and all of those ailments that they have down there, excepting the word "piles," and that does not state that they use the oil but they use an ointment and the capsules, and the ointment or capsules, neither one, are at this time before the court in this contempt proceeding.

We have the exhibits here, with the bottle of oil with the label, and it was prior to the injunction and the label after it was changed.

Now, Mr. Colgrove, from his testimony before this court, shows that he did everything that he possibly could. His intent was to conform with this injunction. He went to a great deal of expense and he very carefully deleted the word "Acne" from that ad, to show how careful he was [21] in arriving at that.

The Court: Mr. McGann, if he wanted to recommend it or suggest it, or if he wanted to suggest it for any of these additional matters such as poison ivy, bed sores, itch, ringworm, etc., could he not have merely added those to the ailments on the label?

Mr. McGann: Well, now, no doubt he could add many things to the label, if the court please, but it is very rarely that you see where they go after the disease itself, regardless of what name it comes under. A man could advertise a cold, actually, and it will be recommended in the advertising for influenza.

The Court: But the purpose of the statute is to have the label be as specific as the inducement. In other words, if a man is going to recommend a drug, isn't the purpose of the statute that his label on the product will, shall I

say, commit him as much as the circular or the advertising or other inducement that he uses for the purchase? Isn't that the purpose of the statute?

And if Mr. Colgrove wants to recommend, as these letters unquestionably do, and probably more studiedly and more forcefully than a direct recommendation by him, this product for athlete's foot, why didn't he put it actually on the label?

Mr. McGann: He did put it on the new label, "athlete's foot." [22]

The Court: Yes. I am sorry. He did.

Mr. McGann: And he deleted the word "Acne" that was more of an oversight than anything else. "Acne" was not put on the label because it was his intention to put "Acne" on the label.

The Court: Take ringworm or bed sores.

Mr. McGann: Ringworm and athlete's foot is the same thing.

The Court: Well, I do not know. Are they?

Mr. McGann: They are; they are considered as such. Athlete's foot is a form of ringworm.

The Court: Well, what are bed sores?

Mr. McGann: Bed sores could be open sores.

The Court: Is there anything on the label that says anything about bed sores?

Mr. McGann: It just tells there how to treat them, the sores, the directions.

The Court: The open sores refer to open sores in connection with psoriasis, eczema, athlete's foot, and leg ulcer.

Mr. McGann: Well, I say it is an open sore, and the directions there are to treat open sores.

The Court: What is poison ivy? Is that covered on the label?

Mr. McGann: Poison ivy and poison oak are the same thing, and they result in what we call an eczema. They [23] are both classified as under the heading of toxicodendron radicans. Poison sumac is practically the same thing, and suppurating skin diseases later treated as eczema.

The Court: Referred to by all the different names in the advertising material but not on the label.

Mr. McGann: It would be almost impossible, if the court please, for one to put on a label the many different names that might be given these various ailments.

The Court: Would it be impossible to put on the label all the different ailments that are mentioned in this advertising material in these testimonial letters?

Mr. McGann: It would take quite a label for that bottle to do it, that sized bottle.

The Court: All the back side could be used, could it not?

This is a field wherein, as I understand it, medical opinion lacks a great deal of certainty. It is easy enough to call all skin eruptions a form of eczema, I suppose; but I doubt that any competent medical man would call them all a form of eczema, don't you?

Mr. McGann: Well, they do not usually indulge in common terms. The average dermatologist, he will go into and give a lot of compound words that are made from the different types of skin, etc., and before we get through we do not know what he is talking about, at any rate. But these are common terms that are used for proprietary drugs. [24]

The Court: In this advertisement there is no suggestion that ringworm and athlete's foot are the same thing, or that poison oak and poison ivy are a form of eczema, is there?

Mr. McGann: Well, there is no definition there of it, no; but I am getting at the meat of the proposition, if the court please, that they could be included with those high-lighted terms that are used there: Eczema, psoriasis, athlete's foot, and leg ulcers.

The Court: The entire complaint here is that they were not included.

Mr. McGann: Well, they could be included, because they are merely common terms that are used by these people that said that they used it for those purposes.

Mr. Colgrove had no intent of violating this injunction at any time. He took the advertisement as it originally was and he tried to fit the label to that, not with the intent of violating the injunction, but with intent to comply with it. He tried to comply with the injunction in every respect, even going to the expense of sending back to Philadelphia and having that shipment returned, yet the shipment was picked up and taken away from him, libeled, when he was trying to live up to this injunction. And, to violate an injunction of this type it requires a criminal intent. That is one of the [25] elements of the violation of an injunction. There must be criminal intent.

The Court: He has to intend to do what he did, doesn't he?

Mr. McGann: What is it?

The Court: The intent—

Mr. McGann: Is not to violate the injunction.

The Court: —is the intention to do what he did.

Mr. McGann: To conform with it. His intention was to conform with the injunction, in good faith. He tried to do everything he possibly could. As he stated, he even withdrew shipments that he could have made here in the State of California, and he could have made them with-

out violating the injunction, because they were intrastate. He did not have to introduce them into interstate. And he brought back all of the shipments that he had made that were available, for the purpose of re-labeling to conform with the order of this court.

I might state, quoting from Dangel on Contempt, it says:

“Criminal contempt must be supported by evidence sufficient to convince the mind of the truth of the facts beyond a reasonable doubt of the actual guilt of the accused. Every element of the offense, including the criminal intent, must be proved by [26] evidence or circumstances warranting an inference of the necessary facts.”

That is from page 76, paragraph 165, of Dangel on Contempt.

At page 75, paragraph 171:

“To constitute criminal contempt acts of disobedience must be characterized by deliberate intention to defy the authority of the court. The act must be done willfully and with the intention to show disrespect for and defiance of the court. Intent is an essential element of the criminal contempt.”

That also quotes two cases from the State of Indiana supporting that paragraph. On page 127, at paragraph 243, it says:

“Although the command of an injunction must be explicitly obeyed, and yet it is in the spirit and not the letter of the command to which obedience is required, but it must be obeyed in good faith according to its spirit.”

Mr. Colgrove has done everything he possibly could to conform with this injunction; and if there was anything done that did not conform with the intent of the injunction, it was not done intentionally, not done for the purpose of showing disrespect of the order. [27]

He went ahead and immediately made the change of the labels, withdrew all of the material that he could from the market to re-label, and in his effort to bring back a consignment that was made to the City of Philadelphia it was picked up on the way and libeled by the United States Court, yet he was trying to conform with this order in good faith.

Mr. Klinger: Your Honor, I merely wanted to point out that in the advertisement itself, you will note that the first testimonial from this doctor who own a hospital in Texas, in that same testimonial he—whoever he is—at least the advertisement itself makes a distinction between poison ivy and eczema. He reports that "out of 40 cases of eczema all but three were cleared of all lesions in three weeks to a month," and so on, and then farther down: "And in eight cases of poison ivy or oak, complete cures were effected in an average of five days."

That would certainly directly tell any reader that there was a difference; and I think it is pretty clear that there is.

And it is precisely what Mr. McGann said about the spirit of the injunction, not only the letter here, not only the spirit, but the letter has been violated.

The intent, as the authority stated that Mr. McGann has read to your Honor, is to be derived from the circum-[28] stances. I think that is true in practically every case, and it is no different in this criminal contempt than in

any other criminal case. It is rarely that the intent can be found on the lips of the defendant.

In this case I do not feel—I feel, I should say, rather, that the evidence points inescapably to the conclusion that this was not an intent to conform with the injunction, but an intent to see with how much he could get away and still have an alluring advertisement which would sell this drug; and in following out that thing he has run directly afoul of this court's preliminary and permanent injunctions.

The Court: Did you have anything further?

Mr. McGann: I just want to comment on counsel's remark, if the court please, and state that what is before the court here on the part of the Government is by stipulation as to their being facts. We stipulated to the allegations of the information as being the facts, but the circumstances were those that were explained by the defendant on the stand.

Now, those circumstances all point only in one direction, that this defendant in everything that he did, he acted in good faith and that he wanted to conform with this order of the court and not be in violation of it.

The Court: The defendant is technically, literally correct in the literal reading of the restraining order, [29] that the label be required to contain specific directions for the use of the product—I am abbreviating that—in the treatment of all ills for which such product is prescribed, recommended, and suggested.

Read literally, the prohibition is against introducing into interstate commerce drugs which do not contain a label containing specific directions for its use in connection with all ills for which it is prescribed and recommended and suggested in the advertising material disseminated by the defendant.

So, literally read, it is true that in order to violate the language of this injunction it would be necessary for the advertising material to prescribe and recommend and suggest the use of the product for the treatment of a condition or an ill or a disease not referred to in the label. That, manifestly, is not the spirit of the injunction.

I think the injunction should, possibly, have been worded in the disjunctive instead of the conjunctive. It should have read "conditions, ills, and diseases for which such product is prescribed or recommended or suggested in the advertising material," but the manifest spirit must be to read it in the disjunctive, because if the advertising material is prescribed, certainly prescription includes "recommendation and the suggestion" and there would be no [30] meaning at all left for the words "recommended and suggested" if the words were used alternatively. As I stated, "prescribed" includes "recommended and suggested."

My view of it is that the defendant attempted to obey the words but not the spirit of the prohibition.

With respect to Counts One to Eight, Counts One, Two, Three, Four, Five, Six, Seven and Eight, I find the defendant, Chester Walker Colgrove, guilty of contempt as charged. With respect to Count Nine of the information I find the defendant, Chester Walker Colgrove, not guilty as charged.

Now, what does the Government recommend?

Mr. Klinger: Your Honor, in connection with the sentence, you will recall that a corporate defendant is also named as a defendant.

The Court: Yes. I think the evidence as to the individual also applies to the corporate defendant—is that correct, counsel?

Mr. McGann: Yes.

The Court: With respect to the defendant, Colusa Remedy Company, a Nevada corporation, I find that corporation guilty of contempt as charged in Counts One, Two, Three, Four, Five, Six, Seven, and Eight of the information, and not guilty of contempt as charged in Count Nine of the information. [31]

What is the recommendation of the Government?

Mr. Klinger: Your Honor, may I make a brief statement in connection with our recommendation?

The Court: Yes.

Mr. Klinger: The Government's recommendation in this case has been carefully considered, because it is not often that we are confronted with a violation of a court decree being prosecuted criminally. The reason that a criminal contempt was instituted in this case was because of the flagrant, deliberate nature of the violation, in the Government's view; and also, of the previous history of these defendants in connection with law enforcement, and particularly in connection with law enforcement under the Food, Drug, and Cosmetic Act.

The defendant Colgrove has been once before convicted on a plea of nolo contendere of a violation, a criminal violation, of the Federal Food, Drug, and Cosmetic Act. The charges on which the defendant has been found guilty in this case are, of course, also criminal violations of the Act itself.

The Court: In view of your recitation from his past record should not this matter be referred to the probation officer?

Mr. Klinger: I make no recommendation with respect to that, your Honor. That matter is entirely within the [32] court's discretion. I have something of the defend-

ant's background, but perhaps a pre-sentence investigation would be worth while.

The Court: What would be your view of that, Mr. McGann?

Mr. McGann: Well, I don't know but what we might be able to present a lot of very interesting matters to the court if it was referred to the probation office. We would perhaps be able to show that this man has been harassed.

The Court: I think I should have all the facts, in view of your reference to past record. This is a field in which, apparently, medical men differ widely. It is a field in which remedies and certainty of treatment is not very satisfactory, apparently; and so in the imposition of any sentence in this matter, I want all the information I can get bearing on the animus of the defendant and the state of mind of the defendant.

Mr. Klinger: Yes, your Honor.

The Court: I will refer the case to the probation officer as to both defendants for pre-sentence investigation and report, and fix January 5th or 12th, whichever meets your convenience.

Mr. Klinger: I would prefer the 5th, your Honor, for my part.

The Court: Is that agreeable to you, Mr. McGann?

Mr. McGann: That will be agreeable to me; yes, your [33] Honor.

The Court: I will fix January the 5th at 1:30 in the afternoon as the time for the hearing of the report and for sentence. There is no bail for appearance, is there?

Mr. Klinger: There is none at the present time, your Honor.

The Court: Does the Government recommend the requirement of bail?

Mr. Klinger: I think that as far as the Government is concerned their own recognizance would be sufficient, I believe.

Mr. McGann: I will be responsible for his appearance, if the court please.

The Court: I am sure that Mr. Colgrove will be here. You are instructed, Mr. Colgrove, to appear personally and on behalf of the corporation in this court on January 5th next at 1:30 for sentence.

[Endorsed]: Filed Feb. 10, 1948. Edmund L. Smith, Clerk. [34]

[Endorsed]: No. 11832. United States Circuit Court of Appeals for the Ninth Circuit. Chester Walker Colgrove, trading and doing business under the firm name of Colusa Remedy Company, and Colusa Remedy Company, a corporation, Appellants, vs. United States of America, Appellee. Transcript of Record. Upon Appeal From the District Court of the United States for the Southern District of California, Central Division.

Filed March 15, 1948.

PAUL P. O'BRIEN

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit

In the United States Circuit Court of Appeals
for the Ninth Circuit

No. 11832

CHESTER WALKER COLGROVE, trading and doing business under the firm name of COLUSA REMEDY COMPANY and COLUSA REMEDY COMPANY, a Nevada corporation,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

POINTS UPON WHICH APPELLANT INTENDS TO RELY UPON APPEAL

Comes now the appellant, Chester Walker Colgrove, trading and doing business under the firm name of Colusa Remedy Company and Colusa Remedy Company, a Nevada corporation, and specifies the following points upon which he intends to rely upon appeal:

I.

The court was without jurisdiction to find the petitioner in contempt. The statute was not designed to cover acts herein charged or to constitute them as subject matter of contempt.

II.

The verdicts and judgments are contrary to the law and the evidence.

III.

The court erred in its rulings and its holdings that one could be guilty of contempt for obeying the letter of the law by offending its spirit.

IV.

The court erred in its holding that one may be punished for a disjunctive act where the basis of the contempt was an order in the conjunctive.

V.

The court erred in its rulings in the procedure and proceedings in the case.

VI.

The court erred in holding that the defendant could be guilty of contempt more than once, if it was guilty of contempt at all, and in dividing and sub-dividing the alleged act. In this respect, the defendant was subject to double jeopardy in violation of the Fifth Amendment to the Constitution of the United States.

VII.

The section of the Statute under which the prosecution was brought, inherently and as construed and applied in this case, is unconstitutional in that it is too vague, indefinite and uncertain to form the basis of a criminal prosecution.

VIII.

The word "advertising" inherently and as construed and applied in this case, is too vague and indefinite to form the basis of a criminal prosecution.

IX.

The trial court misconstrued its power and authority to impose a judgment of contempt where the Statute refers to "advertising", which word, as set forth in the Statute, means merely advertising literature connected with the package itself and could not refer to, or mean, newspaper advertisement. The attempt to apply the Statute to newspaper advertisement violates the First Amendment to the Constitution of the United States permitting freedom of the press.

MORRIS LAVINE
Attorney for Appellant

[Affidavit of Service by Mail.]

[Endorsed]: Filed Mar. 16, 1948. Paul P. O'Brien,
Clerk.

No. 11832

IN THE

United States Court of Appeals
FOR THE NINTH CIRCUIT

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of COLUSA REMEDY COMPANY, and COLUSA REMEDY COMPANY, a Corporation,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

OPENING BRIEF ON APPEAL.

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FILE

SEP 2 1969

TOPICAL INDEX

| | PAGE |
|--|------|
| Jurisdiction | 2 |
| Statutes involved | 2 |
| Questions presented by this appeal..... | 5 |
| Statement of the case..... | 6 |
| Argument | 10 |
| Point I. The original order of the District Court of the United States was not a valid order..... | 10 |
| A. Is the order void as being without the jurisdiction of the court? The complaint in the civil case was for an injunction under 21 U. S. C.(f)(1) and the order and injunction was drawn under both (1) and (2). Did the court in the contempt case exceed its jurisdiction in finding defendants guilty of lack of "specific" direc- tions when only "adequate" required?..... | 11 |
| B. The injunction order was uncertain and indefinite and therefore null and void..... | 15 |
| Point II. The injunction of the court below was beyond its powers under the Food and Drug Act..... | 17 |
| Point III. The attempt to control newspaper advertising by injunction is contrary to the Constitution of the United States | 20 |
| An injunction cannot be used to deny one his constitutional rights of free speech and freedom of the press..... | 22 |

| | PAGE |
|--|------|
| Point IV. The verdicts and judgment are contrary to the law and the evidence, and should be set aside..... | 24 |
| A. The degree of proof required in criminal contempt is "beyond a reasonable doubt"..... | 24 |
| B. Moreover, even aside from the facts discussed above, other evidentiary defects are present in the record..... | 27 |
| Point V. The procedure and proceedings were in violation of due process of law guaranteed by the Fifth Amendment to the Constitution of the United States; the judgments are a nullity and are void..... | 29 |
| A. The rules of criminal procedure must be read and considered together | 30 |
| B. Appellants were denied a trial in the full sense of the term | 30 |
| C. The District Court had no jurisdiction to enter the judgment in this case since the judgment is based both upon alleged contempts and upon alleged violations of law in the commission of "offenses"..... | 33 |
| Point VI. There can be no more than one count for contempt | 34 |
| Point VII. The sentences were excessive..... | 36 |
| Conclusion | 36 |

TABLE OF AUTHORITIES CITED

| CASES | PAGE |
|---|------------|
| Alberty v. United States, 159 F. 2d 278..... | 18 |
| American Medicinal Products v. F. T. C., 136 F. 2d 426..... | 22 |
| Aronberg v. F. T. C., 132 F. 2d 165..... | 22 |
| Beauchamp v. United States, 76 F. 2d 663..... | 11 |
| Berry v. Midtown Service Corp., 104 F. 2d 107..... | 17 |
| Bradley, In re, 318 U. S. 50..... | 35 |
| Carter v. United States, 135 F. 2d 858..... | 34 |
| Charles, etc. v. Federal Trade Commission, 143 F. 2d 676..... | 22 |
| Cohn v. Kramer, 136 F. 2d 293..... | 17 |
| Dailey v. Superior Court, 112 Cal. 94..... | 20 |
| Denver-Greeley Valley Water Users Assn. v. McNeil, 131 F. 2d 67 | 17 |
| Edward G. Budd Mfg. Co. v. N. L. R. B., 142 F. 2d 922..... | 23 |
| Empire Theatre Co. v. Cloke, 53 Mont. 183, 163 Pac. 107..... | 20 |
| Eskay, In re, 122 F. 2d 819..... | 24 |
| Fisk, Ex parte, 113 U. S. 713, 28 L. Ed. 1117..... | 10 |
| Gompers v. Bucks, 221 U. S. 418..... | 24, 25, 31 |
| Grosjean v. American Press Co., 297 U. S. 233..... | 20 |
| Hoffman v. United States, 13 F. 2d 278..... | 35 |
| Hygrade Food Products Corp. v. United States, 160 F. 2d 816.. | 18 |
| Jamison v. Texas, 318 U. S. 413..... | 20 |
| Lustgarten v. Felt & Tarrant Mfg. Co., 92 F. 2d 277..... | 17 |
| M. Kraus & Bros. v. United States, 327 U. S. 614, 90 L. Ed. 894 | 15 |
| Michaelson v. United States, 266 U. S. 42..... | 24 |
| Midland Steel Products Co. v. N. L. R. B., 113 F. 2d 800..... | 22 |
| Miles Laboratories v. F. T. C., 140 F. 2d 683, cert. den. 322 U. S. 752..... | 22 |

| | PAGE |
|---|------|
| National Labor Relations Board v. American Mfg. Co., 132 F. 2d 740, cert. den. 319 U. S. 743..... | 11 |
| National Labor Relations Board v. Bell Oil and Gas Co., 98 F. 2d 405, rehear. den. 99 F. 2d 56..... | 16 |
| National Labor Relations Board v. Ford Motor Co., 114 F. 2d 905, cert. den. 312 U. S. 689..... | 23 |
| National Labor Relations Board v. New York Mdse. Co., 134 F. 2d 949..... | 16 |
| National Labor Relations Board v. Standard Trouser Co., 162 F. 2d 1012..... | 24 |
| Near v. Minnesota, 283 U. S. 697..... | 20 |
| Parker v. United States, 153 F. 2d 66..... | 24 |
| Patterson v. Colorado, 205 U. S. 454..... | 20 |
| People v. Stephens, 79 Cal. 428..... | 35 |
| Rapp v. United States, 146 F. 2d 548..... | 35 |
| Research Laboratories v. United States, 126 F. 2d 42; cert. den. 317 U. S. 656..... | 18 |
| Rowland, Ex parte, 104 U. S. 604, 26 L. Ed. 861..... | 10 |
| Russell v. United States, 86 F. 2d 389..... | 24 |
| Sawyer, Re, 124 U. S. 200, 31 L. Ed. 402..... | 10 |
| Schenck v. United States, 249 U. S. 47..... | 20 |
| Schmidt v. United States, 115 F. 2d 394..... | 24 |
| Stromberg v. California, 283 U. S. 359..... | 20 |
| Sullivan v. United States, 161 F. 2d 629..... | 18 |
| Terminal R. Assn. of St. Louis v. United States, 266 U. S. 17.... | 17 |
| United States v. 50 $\frac{3}{4}$ Bottles of Sulfa-Seb, et al., 54 F. S. 759 | 25 |
| United States v. Cruikshank, 92 U. S. 542, 23 L. Ed. 588..... | 34 |
| United States v. United Mine Workers, 91 L. Ed. 884..... | 26 |
| Viereck v. United States, 318 U. S. 236, 87 L. Ed. 734..... | 10 |

DICTIONARY

STATUTES**PAGE**

| | |
|--|-------|
| Federal Food, Drug and Cosmetic Act (21 U. S. C. A., Sec. 301 ff.) | 2 |
| Federal Food, Drug and Cosmetic Act (21 U. S. C., Sec. 321) | 2, 10 |
| Federal Rules of Criminal Procedure, Rule 10..... | 4 |
| Federal Rules of Criminal Procedure, Rule 11..... | 4 |
| Federal Rules of Criminal Procedure, Rule 42..... | 4 |
| Federal Trade Commission Act, Secs. 12, 13 (15 U. S. C. A., Secs. 52, 53)..... | 21 |
| United States Code Annotated, Title 15, Sec. 53(a)..... | 21 |
| United States Code Annotated, Title 15, Sec. 55..... | 22 |
| United States Code Annotated, Title 21, Sec. 332..... | 2 |
| United States Code Annotated, Title 21, Sec. 332(b)..... | 2 |
| United States Code Annotated, Title 21, Sec. 352 | 3, 11 |
| United States Code Annotated, Title 28, Sec. 387..... | 2 |
| United States Code, Title 21, Sec. 331..... | 3 |
| United States Code, Title 21, Sec. 333..... | 3 |
| United States Code, Title 28, Sec. 225..... | 2 |
| United States Constitution, First Amendment..... | 6, 20 |

No. 11832

IN THE

**United States Court of Appeals
FOR THE NINTH CIRCUIT**

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of COLUSA REMEDY COMPANY, and COLUSA REMEDY COMPANY, a Corporation,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

OPENING BRIEF ON APPEAL.

This is an appeal from judgments and sentences pronounced against Chester Walker Colgrove, trading and doing business under the firm name of Colusa Remedy Company and Colusa Remedy Company, a Nevada corporation, defendants.

The charges grow out of the sale of Colusa Natural Oil in drug stores and advertising material published in local daily newspapers setting out where the product might be obtained from drug stores and doctors.

This brief challenges the right of the court to issue an injunction limiting newspaper advertising as not within the authority granted to the court by Congress. Other fundamental issues are also presented by this appeal.

Jurisdiction.

Jurisdiction—Title 28, Section 225, U. S. Code, and 21 U. S. C. A., Section 332, and 28 U. S. C. A., Section 387, and the Rules of Criminal Procedure of the rules of the court of the United States.

The United States Attorney for the Southern District of California filed an “Information Re Contempt (Criminal)” under Sections 21 U. S. C. A. 332(b) and 28 U. S. C. A. 387, in the United States District Court for the Southern District of California, Central Division, before Hon. Judge William C. Mathes, U. S. District Judge, on October 2, 1947 [R. 2-15].* Judge Mathes issued an Order to Show Cause re Criminal Contempt” on October 3, 1947 [R. 17, 45 ff.]. A hearing upon that Order was held on December 8, 1947 [R. 27]. A “trial” was held on December 19, 1947 [R. 27, 55 ff.]. Judgment of conviction and sentences were entered on January 5, 1948 [R. 34-38]. Notice of Appeal was filed on January 12, 1948 [R. 39-40].

Statutes Involved.

The Federal Food, Drug and Cosmetic Act (21 U. S. C. A. 301 ff.) provides (21 U. S. C. 321) :

“Definitions:

“For the purposes of this chapter—

* * * * *

“(k) The term ‘label’ means a display of written, printed or graphic matter upon the immediate container of any article; * * *

* * * * *

*The references preceded by “R” are to the printed record on appeal herein.

“(m) The term ‘labeling’ means all labels and other matter, printed or graphic matter (1) upon any article or any of its containers or wrappers, or

“(2) accompanying such article.”

(21 U. S. C. 331):

“Prohibited Acts:

“The following acts and the causing thereof are hereby prohibited:

“(a) The introduction or delivery for introduction into interstate commerce of any * * * drug that is * * * misbranded.”

(21 U. S. C. 333):

“Penalties—Violation of Section 331:

“(a) Any person who violates any of the provisions of Section 331 shall be guilty of a misdemeanor and shall on conviction thereof be subject to imprisonment * * * or a fine * * * or both * * *.”

(21 U. S. C. A. 352):

“Misbranded Drugs and Devices:

“A drug or device shall be deemed to be misbranded—

“(a) If its labeling is false or misleading in any particular.

* * * * *

“(f) Unless its labeling bears (1) adequate directions for use; and (2) such adequate warnings against use in those pathological conditions or by children where its use may be dangerous to health, or against unsafe dosage or methods or duration of administration or application, in such manner and form, as are necessary for the protection of users.”

Rule 10, Federal Rules of Criminal Procedure:

“Rule 10. *Arraignment.*

“Arraignment shall be conducted in open court and shall consist of reading the indictment or information to the defendant or stating to him the substance of the charge and calling on him to plead thereto. He shall be given a copy of the indictment or information before he is called upon to plead.”

Rule 11, Federal Rules of Criminal Procedure:

“Rule 11. *Pleas.*

“A defendant may plead not guilty, guilty, or, with the consent of the court, *nolo contendere*. The court may refuse to accept a plea of guilty, and shall not accept the plea without first determining that the plea is made voluntarily with understanding of the nature of the charge. If a defendant refuses to plead or if the court refuses to accept a plea of guilty or if a defendant corporation fails to appear, the court shall enter a plea of not guilty.”

Rule 42, Federal Rules of Criminal Procedure:

“Rule 42. *Criminal Contempt.*

“(a) *Summary Disposition.* A criminal contempt may be punished summarily if the judge certifies that he saw or heard the conduct constituting the contempt and that it was committed in the actual presence of the court. The order of contempt shall recite the facts and shall be signed by the judge and entered of record.

“(b) *Disposition Upon Notice and Hearing.* A criminal contempt except as provided in subdivision (a) of this rule shall be prosecuted on notice. The notice shall state the time and place of hearing, allow-

ing a reasonable time for the preparation of the defense, and shall state the essential facts constituting the criminal contempt charged and describe it as such. The notice shall be given orally by the judge in open court in the presence of the defendant or, on application of the United States attorney or of an attorney appointed by the court for that purpose, by an order to show cause or an order of arrest. The defendant is entitled to a trial by jury in any case in which an act of Congress so provides. He is entitled to admission to bail as provided in these rules. If the contempt charged involves disrespect to or criticism of a judge, that judge is disqualified from presiding at the trial or hearing except with the defendant's consent. Upon a verdict or finding of guilt the court shall enter an order fixing the punishment."

Questions Presented by This Appeal.

1. Whether the original order of the District Court of the United States was a valid order?
2. Whether the District Court had jurisdiction under the orders so issued to find the petitioners in contempt of court?
3. Whether the verdicts of the District Court are contrary to the law and the evidence?
4. Whether the District Court erred in holding that the petitioners were guilty of criminal contempt where—according to the court's own determination—there was actual compliance with the orders of the court but not "spiritual" compliance?
- 5: Whether the District Court misconstrued the language of the statutes regarding advertising?

6. Whether the statute forbids newspaper advertisements when the same do not accompany the drug?
7. Whether advertisements in newspapers come within the protection of the First Amendment to the Constitution of the United States and are not prescribed by the statute?
8. Whether the sentences were null and void where there were consecutive sentences?
9. Whether the judgment on the first count, if valid, rendered all the other counts *res judicata*?

Statement of the Case.

On February 24, 1947, the District Court below, the Honorable Judge Mathes presiding, issued a preliminary injunction against appellants, restraining them

“from introducing or delivering for introduction into interstate commerce, in any form or manner, the product known as ‘Colusa Natural Oil,’ or any like product, without a label containing *specific* directions for the use of such product in the treatment of all conditions, ills and diseases for which such product is prescribed, recommended, and suggested, in the advertising material disseminated or sponsored by or on behalf of the defendants or either of them; which directions shall include the quantity of dose (including quantities for (2) persons of different ages and different physical conditions) to be taken or applied in the treatment of each of such conditions, ills and diseases, as well as the recommended frequency and

duration of administration or application of such dosage" (italics ours) [R. 2-3].

On April 23, 1947, the court made the injunction permanent, changing, however, the word "specific" to "adequate" [R. 3].

Thereafter appellants shipped Colusa Natural Oil in interstate commerce on various dates, labeled as follows [R. 4, 22]:

"A natural unrefined petroleum oil intended for use in the treatment of Psoriasis, Eczema, Athlete's Foot, and Leg Ulcers.

"Directions: Apply to affected parts and rub it in thoroughly morning and night. For open sores, saturate cotton pad with oil and bind on by gauze. Change to fresh dressing morning and night. For tender skin oil can be diluted 50% with olive (3) oil. Continue treatment until skin is smooth and comfortable. * * *"

Appellants also placed advertisements in local newspapers in various states concerning their product [R. 20].

It is by reason of the advertisements in local newspapers in various states that the court found the petitioners guilty of contempt.

On October 2, 1947, the United States Attorney for the Southern District of California filed in the District Court of the United States for that district, Central Division, before the Honorable Judge William C. Mathes,

United States District Judge, an "Information re Contempt (Criminal)" [R. 2-15], in nine "counts," each of which charged a separate act or series of acts alleged to be "in criminal contempt" of a temporary or permanent injunction previously issued against appellants by that Judge.

On October 3, 1947, Judge Mathes issued an order to show cause directed to appellants, requiring them to appear before him and show cause why they should not be held in criminal contempt of that court [R. 16-16]. On December 8, 1947, a hearing was held before that Honorable Judge upon said order to show cause, and the Judge concluded that appellants had not purged themselves of contempt, and ordered that they stand trial [R. 17].

Appellants were tried before Judge Mathes, having waived a jury, on December 19, 1947 [R. 27, 55 ff.], and were found guilty of contempt as charged in counts one to eight, inclusive, of the Information, and not guilty as to count nine [R. 27, 78].

In finding appellants guilty, the court stated that appellant Colgrove was "technically, literally correct in the literal reading" of the injunctions [R. 77]. The court further stated that the injunction should have been worded differently, in the disjunctive rather than in the conjunctive, and that in order to violate the injunction as written, it would have been necessary for the advertising material involved (see *infra*) to contain a conjunction of various matters [R. 78]. The court, stating that the appellant Colgrove "attempted to obey the words

but not the spirit of the prohibition" in the injunctions, nevertheless found appellants guilty of criminal contempt [R. 78].

The court sentenced on January 5, 1948, appellant Colgrove to fines totalling \$4,000 and to imprisonment for a total period of six months, and then suspended the jail terms and placed him on probation for five years [R. 37-38]. The corporation was fined \$5,000 [R. 39].

This appeal followed, to have the issues determined in this court.

Judgment of conviction and sentence, which recites in part that appellants "had been convicted" after trial "of the offense" of shipping certain products in interstate commerce and in disregard of the injunctions, was entered by the court on that date [R. 34-38]. While the judgment also recites that conviction was had after trial upon a "plea of not guilty," no pleas were in fact taken or offered, as far as is shown by the record on appeal.

ARGUMENT.

POINT I.

The Original Order of the District Court of the United States Was Not a Valid Order.

The court was without jurisdiction to make an order restraining the appellants from prescribing, recommending, or suggesting any advertising material designated by or on behalf of the defendants, or either of them, which advertising material

(1) Was not placed upon any article or any of its contents or labels, or

(2) Did not actually accompany such article.

Title 21, U. S. C., Section 321, says: "The term label means a display of written, printed, or graphic matter *upon the immediate container of any article*." Therefore, the court was without jurisdiction to issue an injunction of the kind or character which it did issue [R. 23], and which was therefore null and void.

Where an order is made which is null and void, the same may be disregarded. (See *Re Sawyer*, 124 U. S. 200, 31 L. Ed. 402; *Ex parte Fisk*, 113 U. S. 713, 28 L. Ed. 1117; *Ex parte Rowland*, 104 U. S. 604, 26 L. Ed. 861.)

It is for the legislature and not the courts to determine the statute and extent to which the statute governs and one cannot be held criminally liable for violating either a statute or a regulation pursuant thereto for which there is no statutory authority. The mode prescribed by the statute is the measure of power. (*Viereck v. United States*, 318 U. S. 236, 87 L. Ed. 734.)

A. Is the Order Void as Being Without the Jurisdiction of the Court? The Complaint in the Civil Case Was for an Injunction Under 21 U. S. C.(f)(1) and the Order and Injunction Was Drawn Under Both (1) and (2). Did the Court in the Contempt Case Exceed Its Jurisdiction in Finding Defendants Guilty of Lack of "Specific" Directions When Only "Adequate" Required?

Disobedience of a void order or one issued by a court without jurisdiction of the subject-matter and parties litigant is not contempt.

Beauchamp v. U. S., 76 F. 2d 663 (C. C. A. 9).

A decree entered with jurisdiction must be obeyed as entered, and if its terms read more broadly than defendant intended in consenting thereto, time and manner of avoiding that breadth was by objection to the decree before its entry and not by disobedience.

N. L. R. B. v. American Mfg. Co., 132 F. 2d 740 (cert. den. 319 U. S. 743).

The civil case out of which the alleged contempt arose (No. 5992-WM—Civil in the District Court) was for an injunction under Section 352 of Title 21, U. S. C., subdivision (f)(1). While the complaint prays for an injunction under (f)(1) only, the injunction was drawn to include (f)(2). Therefore, I am quoting below the entire subsection:

"§352. Misbranding drugs and devices.

"A drug or device shall be deemed to be misbranded— * * *

"(f) Directions for use and warnings on label.

"Unless its labeling bears (1) adequate directions for use; and (2) such adequate warnings against use

in those pathological conditions or by children where its use may be dangerous to health, or against unsafe dosage or methods or duration of administration or application, in such manner and form, as are necessary for the protection of users: Provided, That where any requirement of clause (1) of this paragraph, as applied to any drug or device, is not necessary for the protection of the public health, the Administrator shall promulgate regulations exempting such drug or device from such requirement."

This statute, in both subdivisions, require but "adequate" labeling. The preliminary injunction required "specific" directions as to the use of the product. This was changed to "adequate" directions in the final injunction [R. 3]. But this confusion continued throughout the entire contempt proceedings. Newspaper advertising cannot be considered "labeling." The court exceeded its jurisdiction in including "advertising material" in its injunction when the statute only requires adequate labeling.

The information on which the defendants were tried alleges the lack of "specific" directions in counts one and five; of "adequate" directions in counts two, three, six, seven, eight and nine and of "specific or adequate" directions in count four.

The trial court found that the defendants failed to give "specific" directions [R. 34 and 36] as shown by its remarks on page 77 of the record:

"The Court: The defendant is technically, literally correct in the literal reading of the restraining order, that the label be required to contain *specific* directions for the use of the product—I am abbreviating that—in the treatment of all ills for which such product is prescribed, recommended, and suggested.

“Read literally, the prohibition is against introducing into interstate commerce drugs which do not contain a label containing *specific* directions for its use in connection with all ills for which it is prescribed and recommended and suggested in the advertising material disseminated by the defendant. * * *”

If all that the statute or the injunction requires is “adequate” directions as to the use of the product the defendants cannot be found in contempt for failing to give “specific” directions. General directions for the use of a product such as the one involved in this case may be “adequate” while not “specific” whereas, with a different product which might be dangerous to health if not properly used or if used by a child instead of an adult the same directions would not be adequate. There is no contention on the part of the government that the product was dangerous to health or that the use is different for children than for adults. In fact, the same directions apply to both and also apply to any disease prescribed, recommended or suggested in the advertisement.

The directions were adequate for the reason that all of the diseases mentioned are of the same kind. The principles of *Eiusdem Generis* or *Noscitur a Sociis*, to use legal terminology, would apply.

The American Illustrated Medical Dictionary (Dorland) 20th Ed., defines eczema as “an inflammatory skin disease with vesiculation, infiltration, watery discharge, and *the development of scales and crusts*. The lesions vary much in character, and the disease is frequently attended with restlessness and fever and other symptoms of constitutional disturbance, as well as by local *itching and burning*.” This definition is followed by the particularization of forty-four different types of eczema.

The definition of psoriasis is “a skin disease of many varieties, characterized by the formation of *scaly red patches* on the extension surfaces of the body.” This definition is followed by a list of nineteen different types of psoriasis including psoriasis annularis which is defined as “*psoriasis in ring shaped patches*”; and psoriasis nummularis which is “*psoriasis in circular patches* which resemble small coins.”

Athlete’s foot is defined by the same author as “*ring-worm* of the feet; a dermatophytosis of the skin of the feet, characterized by the formation of vesicles, redness and the development of cracks between the toes, resulting in itching, pain, and some disability.”

Poison ivy is defined as “*Rhus Toxicodendron*—or poison ivy, a poisonous species of sumac. The leaves or juice, when applied to the skin, cause a severe dermatitis and internal poisoning.”

Poison oak is not even defined. Under “poison oak” the dictionary says “see *Rhus Diversiloba*” and under that term is the statement “is poison oak.”

An ulcer is defined as “an open sore, other than a wound,” etc. This is followed by 128 different types of ulcer which includes “*decubitis ulcer*”—a *bedsore*, an ulceration caused by prolonged pressure in a patient confined to bed for a long period of time.

A study of the above definitions will disclose that practically every term used in the advertisement comes within one or the other of the terms used in the main portion of the advertisement, to-wit psoriasis, athlete’s foot, eczema or ulcers. Every one is but an irritation of the skin. Every one should be treated in the same manner; exactly as directed on the label. What more could be expected of the defendants?

Should they have listed the 44 different types of eczema in order to show that it would relieve burning and itching? Should they have listed the 19 different types of psoriasis in order to show that it could be used for scaly red patches on the skin and ringworm. Should they have specified both athlete's foot and ringworm when athlete's foot is but a form of ringworm? I maintain that the directions for use were more than adequate, and cover all of the ills, conditions and diseases for which the product is prescribed, recommended and suggested.

B. The Injunction Order Was Uncertain and Indefinite and Therefore Null and Void.

An injunction order, similar to any Administrative Order, must be so definite and certain that anyone would clearly come within its language and meaning or it is null and void.

M. Kraus & Bros. v. United States, 327 U. S. 614, 90 L. Ed. 894.

In *Kraus & Bros. v. United States*, 327 U. S. 614, 90 L. Ed. 894 at page 899, the court said:

"The elements of evasive conduct should be so clearly expressed by the Administrator that the ordinary person can know in advance how to avoid an unlawful course of action.

In applying this strict rule of construction to the provisions adopted by the Administrator, courts must take care not to construe so strictly as to defeat the obvious intention of the Administrator. Words used by him to describe evasive action are to be given their natural and plain meaning, supplemented by contemporaneous or long-standing interpretations publicly made by the Administrator. But patent omissions

and uncertainties cannot be disregarded when dealing with a criminal prosecution. A prosecutor in framing an indictment, a court in interpreting the Administrator's regulations or a jury in judging guilt cannot supply that which the Administrator failed to do by express word or fair implication. Not even the Administrator's interpretations of his own regulations can cure an omission or add certainty and definiteness to otherwise vague language. **The prohibited conduct must, for criminal purposes, be set forth with clarity in the regulations and orders which he is authorized by Congress to promulgate under the Act.** Congress has warned the public to look to that source alone to discover what conduct is evasive and hence likely to create criminal liability. *United States v. Resnick*, 299 U. S. 207, 81 L. Ed. 127, 57 S. Ct. 126."

So a court injunction must likewise be set forth with clarity by express words.

One may not be punished for disobedience of an order which does not definitely prescribe what he is to do.

N. L. R. B. v. New York Mdse. Co., 134 F. 2d 949.

A person acting in good faith and with due respect to the court is not guilty of contempt if placed in a dilemma by an ambiguous order of the court.

N. L. R. B. v. Bell Oil and Gas Co., 98 F. 2d 405, rehearing denied, 99 F. 2d 56.

Before a person should be subjected to punishment for violating a command of the court, the order should inform

him in definite terms regarding duties thereby imposed upon him.

Berry v. Midtown Service Corp., 104 F. 2d 107.

The decree cannot be expanded by implication and the facts found must constitute a *plain violation* of the decree.

Denver-Greeley Valley Water Users Assn. v. McNeil, 131 F. 2d 67;

Cohn v. Kramer, 136 F. 2d 293;

Terminal R. Assn. of St. Louis v. U. S., 266 U. S. 17;

Lustgarten v. Felt & Tarrant Mfg. Co., 92 F. 2d 277.

POINT II.

The Injunction of the Court Below Was Beyond Its Powers Under the Food and Drug Act.

The extent of the power of the court below to enjoin appellants in their acts with reference to their shipment of drugs in interstate commerce is controlled by the provisions of the Food and Drug Law (*supra*). That law, as applicable here, prohibits the introduction into interstate commerce of any drugs which are misbranded, that is, not properly labelled as defined under that act (see *supra*).

Nothing in that Act indicates that Congress desired its prohibitions to operate upon newspaper advertisements. In fact, the writings referred to in that Act relate specifically to advertising material *upon the package containing the drug or accompanying the package*.

This Court has recently had occasion to decide that advertising material, which was expressly designed to

be distributed in conjunction with the product involved, did not accompany that product within the meaning of the Act when the advertising material was sent days after the shipment in interstate commerce of the drug itself.

Alberly v. United States, 159 F. 2d 278 (C. C. A. 9, 1947).

See also

Research Laboratories v. United States, 126 F. 2d 42 (C. C. A. 9), cert. den. 317 U. S. 656.

Here the advertisements dealt with in the injunction were advertisements in newspapers, which did not accompany the drug, and which were not even shown to have been in interstate commerce at all. The power of the court below to enjoin acts of appellants with respect to advertisements was no broader than the prohibitory terms of the statute itself. Since the statute's proscriptive and mandatory terms are specifically with relation to the label on the package or advertising material *accompanying* the package, the court below could only prohibit or require acts on the part of appellants which were within the scope of the law from which the court derived its power to enjoin. By including requirements in its injunction as to advertising in newspapers which did not accompany the product in interstate commerce, the court below plainly acted beyond its jurisdiction.

See, *e. g.*,

Hygrade Food Products Corp. v. United States, 160 F. 2d 816 (C. C. A. 8, 1947).

Cf. Sullivan v. United States, 161 F. 2d 629 (C. C. A. 5, 1947).

And since the contempt was predicated upon acts of appellants with reference to the *newspaper advertisements*, the jurisdiction of the court to issue its injunctions, and later to find appellants in contempt, did not exist here. At the hearing upon the order to show cause, the court asked [R. 53]: “Is it the Government’s contention that this advertisement becomes in effect a part of the label.”

Thereupon counsel for the Government replied [R. 53]:

“*Not necessarily a part of the label, your Honor, no;* but it is in conflict with the court’s order heretofore entered, which is, pursuant to the statute, that the defendants *are not in their advertising*, after these injunctions, to recommend, suggest or prescribe this product for any conditions, *any of the disease conditions* other than those named on the label.” (Italics ours.)

It is undisputed that appellant deleted the word “acne” from the advertisements [R. 30, 33] after the first injunction was issued, because “acne” was not referred to on the labels [R. 59-60]. Nothing more was in fact required of appellants under the injunctions in this case.

Aside from this fact that appellants complied in full as required of them under the terms of the injunctions, there are the further points, discussed elsewhere in this brief, which demonstrate that the injunctions were beyond the powers of the court below, and were improper for other reasons.

POINT III.

The Attempt to Control Newspaper Advertising by Injunction Is Contrary to the Constitution of the United States.

The Constitution of the United States guarantees freedom of the press.

See *e. g.*

Constitution, United States, First Amendment;
Stromberg v. California, 283 U. S. 359;
Grosjean v. American Press Co., 297 U. S. 233;
Schenck v. United States, 249 U. S. 47;
Jamison v. Texas, 318 U. S. 413.

That constitutional guaranty implies freedom from previous restraints upon publication.

Patterson v. Colorado, 205 U. S. 454;
Near v. Minnesota, 283 U. S. 697;
Dailey v. Superior Ct., 112 Cal. 94;
Grosjean v. American Press Co., 297 U. S. 233.

And this freedom is safeguarded not only from legislative action, but also from judicial restraint.

E. g.,

Near v. Minnesota, 283 U. S. 697;
Dailey v. Superior Ct., 112 Cal. 94;
Empire Theatre Co. v. Cloke, 53 Mont. 183, 163 Pac. 107.

Here the trial court exercised its injunctive power in an attempt to place a previous restraint upon publication. Moreover, the court did not even limit its injunction to

advertising matter in interstate commerce. In punishment of an alleged disregard of that restraint, the court held appellants in contempt.

It is plain, we submit, that the court's actions were contrary to the provisions of the Constitution.

Moreover, even under existing statutes, irrespective of constitutionality, the court below was clearly in error in seeking to control newspaper advertisements by appellants. Newspaper advertising is within the exclusive province of the Federal Trade Commission. (See Secs. 12 and 13 of the Federal Trade Commission Act (15 U. S. C. A. 52, 53).)

Nothing in the Food and Drug Act confers jurisdiction upon a federal court to deal with that subject matter.

No proceeding was had here under the Federal Trade Commission Act.

The Federal Trade Commission, also, proceeds in the District Courts of the United States by its own attorneys, not through the United States Attorney, to enforce the provisions of its Act. (15 U. S. C. A. 53(a).) No such proceeding under that law has been brought here.

Furthermore, there is no evidence in this case that any of the newspapers in which appellants' advertisements appeared, were ever mailed or in interstate commerce. Such a showing is required, of course, even under the Federal Trade Commission Act. And there is no proof in this case that any part of the advertisements by appellants was false or misleading.

Under the Federal Trade Commission Act, that commission can determine falsity only on the basis of proper and adequate proof.

See:

15 U. S. C. A. 55;

Charles, etc., v. Federal Trade Commission, 143 F. 2d 676 (C. C. A. 2);

Aronberg v. F. T. C., 132 F. 2d 165;

American Medicinal Products v. F. T. C., 136 F. 2d 426 (C. C. A. 9);

Miles Laboratories v. F. T. C., 140 F. 2d 683, cert. den. 322 U. S. 752.

And such a conclusion can only be reached in a duly constituted and conducted hearing before that agency. None was here shown to have been held.

An Injunction Cannot Be Used to Deny One His Constitutional Rights of Free Speech and Freedom of the Press.

“Unless the right of free speech is enjoyed by employers as well as by employees, the guaranty of the First Amendment is futile, for it is fundamental that the basic rights guaranteed by the Constitution belong equally to every person.”

Midland Steel Products Co. v. N. L. R. B., 113 F. 2d 800 at page 804 (C. C. A. 6).

"Nowhere in the National Labor Relations Act is there sanction for an invasion of the liberties guaranteed to all citizens (persons) by the First Amendment."

N. L. R. B. v. Ford Motor Co., 114 F. 2d 905, 915 (C. C. A. 6), cert. den. 312 U. S. 689.

"A contempt proceeding may serve in appropriate circumstances as the efficient means for vindicating a court's judgments or decrees, but 'it is of prime importance that no constitutional freedom, least of all the guarantees of the Bill of Rights, be defeated by insubstantial findings of fact screening reality.' See Milk Wagon Drivers Union v. Meadowmoor Dairies, Inc., 312 U. S. 287, 298, 61 S. Ct. 552, 555, 85 L. Ed. 836, 132 A. L. R. 1200 (concerning the rights under the Fourteenth Amendment). * * *

"* * * The right to free speech in the future is not to be forfeited because of misconduct in the past. * * * This must necessarily be so if freedom of speech which is 'among the fundamental personal rights and liberties' (*Lovell v. City of Griffin*, 303 U. S. 444, 450, 58 S. Ct. 666, 668, 82 L. Ed. 949) is to be maintained inviolate. That the right is to be so maintained calls for no argument."

Edward G. Budd Mfg. Co. v. N. L. R. B., 142 F. 2d 922 at page 928.

POINT IV.

The Verdicts and Judgment Are Contrary to the Law and the Evidence, and Should Be Set Aside.

A. The Degree of Proof Required in Criminal Contempt Is “Beyond a Reasonable Doubt.”

In prosecution for criminal contempt evidence must show guilt of accused *beyond a reasonable doubt*.

Russell v. U. S., 86 F. 2d 389;

Schmidt v. U. S., 115 F. 2d 394.

If a respondent is answering a charge of criminal contempt, he is presumed to be innocent and must be proved to be guilty beyond a reasonable doubt and cannot be compelled to testify against himself.

Parker v. U. S., 153 F. 2d 66;

In re Eskay, 122 F. 2d 819;

Gompers v. Bucks, 221 U. S. 418;

Michaelson v. U. S., 266 U. S. 42.

Contempt of court is a grave thing and the court is not disposed to engage in strained construction to spell out some theoretical abstract violation of the court's order.

N. L. R. B. v. Standard Trouser Co., 162 F. 2d 1012.

The last case cited is a civil contempt where the degree of proof required is only a preponderance of the evidence. In a criminal contempt with the presumption of innocence and proof beyond a reasonable doubt required the court should be even more strict in the degree of proof required. See the court's remarks, quoted *supra*, on page 77 of the record where the court admits that the defendants were

literally correct in their interpretation of the court's order. This also ties into the remarks and cases cited under the subdivision above re UNCERTAINTY AND INDEFINITENESS OF THE INJUNCTION.

In connection with the proof in this case see:

United States v. 50 3/4 Bottles of Sulfa-Seb, et al.,
54 F. S. 759,

where it was held in a libel proceeding involving misbranding of certain drugs that evidence consisting of letters received from purportedly satisfied customers to questionnaires mailed out by claimants was inadmissible as hearsay. The testimonials published with the advertisement were unsolicited, couched in untechnical language and as shown *supra* the language used in practically all instances is used in the technical definition of the terms used in large type.

The evidence does not meet the test of guilt beyond a reasonable doubt.

It is elementary that in a criminal contempt proceeding, as in a criminal cause, findings of guilt must be based upon evidence which shows such guilt beyond a reasonable doubt, and the burden of proof is on the prosecution.

See, *e. g.*,

Gompers v. Bucks Stove & Range Co., 221 U. S. 418, 55 L. Ed. 797.

No such showing can be found in this case.

The evidence here demonstrated that, in a field of legal interpretations and constructions of technical terms contained in the Food and Drug Act and in the injunctions of the court, appellant Colgrove reached a fair conclusion as to what was required of him, and acted accordingly

[R. 63], but the conclusion ultimately turned out to be different from that reached by the court upon the trial [R. 56-66, 68, 71-73, 77-79]. A question of interpretation was involved; not a criminal disregard of the mandate of a court.

That appellant was not unreasonable in his interpretation of the injunction, was indicated by the trial judge himself, the judge who had issued the injunction in the first instance, when he said [R. 77] that "the defendant is technically, literally correct in the literal reading of the restraining order."

The court continued:

"So, literally read, it is true that in order to violate the language of this injunction it would be necessary for the advertising material to prescribe and recommend and suggest the use of the product for the treatment of a condition or an ill or a disease not referred to in the label." [R. 78.] * * * I think the injunction should, possibly, have been worded in the disjunctive instead of the conjunctive." [R. 78.] * * * "My view is that defendant attempted to obey the words but not the spirit of the prohibiton." [R. 78.]

It is clear, we submit, that there is no evidentiary basis beyond a reasonable doubt of a criminal disregard of the injunction of the court below; for it is only "one who defies the public authority and *wilfully* refuses his obedience," who is guilty of contempt. *United States v. United Mine Workers*, 91 L. Ed. 884, 918 (italics ours). And there is similarly no basis for the conclusion, reached by the trial court upon the hearing upon the order to show cause [R. 53], that appellant Colgrove had not purged himself of criminal contempt.

**B. Moreover, Even Aside From the Facts Discussed Above,
Other Evidentiary Defects Are Present in the Record.**

(1)

There is no evidence, for instance, that the label or the advertising involved in the case, and upon which the findings of the court below must rest, were in use by appellants on the date of the hearing or the trial below.

The record demonstrates [R. 53] that the trial court merely *assumed* that the label and the advertising were then in use. The court stated [R. 53]:

“Is it still being used, that type of advertisement? There is no showing it is not still being used. *I assume it is and the label is.*” (Italics ours.)

No citation of authority is required for the proposition that a criminal contempt proceeding or a criminal cause cannot be predicated or proceed upon findings of positive facts made on the basis of assumptions based upon absence of proof. And no finding of guilt in either a criminal contempt proceeding or in a criminal cause, both requiring proof beyond a reasonable doubt, can be bottomed upon such “evidence.”

(2)

Then, there is nothing in the record to show that the label was not sufficiently specific in its directions for use of the contents. No proof was offered by the Government to support its contention of misbranding and no proof was offered to show that the label did not comply with the law.

The label on its face [see *e. g.* R. 4] bears specific “Directions” for use. Nothing in the record shows that these directions were either inadequate or misleading, either as to the conditions mentioned directly on the label, or even

those which the Government contended were additional conditions, allegedly mentioned in the newspaper advertisements. As far as the record shows, the directions for use contained on the label, are complete and adequate.

As the court below remarked [R. 73]: "This is a field where, as I understand it, medical opinion lacks a great deal of certainty." Criminal contempt findings should be based on something more substantial than a resolution of conflicting views in an uncertain field.

(3)

While the Government apparently contended below that the conditions referred to in the newspaper advertisements were additional to those mentioned on the drug label, the record is devoid of proof to that effect.

On the contrary, positive uncontradicted proof is present in the record that all conditions for which the drug here might be used, are fully covered by the terms on the label.

Thus appellant Colgrove testified without contradiction [R. 59, 62-63] that those conditions which the Government claimed were mentioned additionally in the advertisements, were in fact the same as those enumerated on the label; that he had the label reprinted after the first injunction was issued to comply with its terms as he understood them; and that he did everything within his power and in good faith to conform to the court's requirements [R. 63].

It is clear that this is "a field in which, apparently, medical men differ widely. It is a field in which remedies and certainty of treatment is not very satisfactory," as the court said below [R. 80]. Plainly no basis for a finding of criminal contempt existed in this case.

Without going into further detailed discussion of the evidence, or rather lack of evidence necessary to sustain the judgment below, we submit that the Government has failed to meet the test of guilt beyond a reasonable doubt, and that the conviction here should be reversed on that ground.

POINT V.

The Procedure and Proceedings Were in Violation of Due Process of Law Guaranteed by the Fifth Amendment to the Constitution of the United States; the Judgments Are a Nullity and Are Void.

The judgments are void. The entire proceedings in this case were a hotch-pot. While the information is labeled "Re Contempt (Criminal)" [R. 2], they were neither criminal nor civil; they were neither fish nor fowl; they were neither animal nor vegetable.

We take it that in a criminal contempt proceeding that the Rules of Criminal Procedure, as set down by the rules, must be complied with or the proceedings are a nullity.

Here the proceedings started out as a civil proceeding with an Order to Show Cause being issued against the defendants [R. 16]. This, of course, followed the issuance of the information [R. 2] upon the appearance of the defendants (by defendants, that is the corporations and the defendant Colgrove) "to show cause why they should not be punished for contempt" [R. 17].

The court found that the defendants had not purged themselves of contempt and set the cause for trial [R. 17].

There was no arraignment and no plea.

Without an arraignment or without plea a criminal proceeding has not taken place and the procedure and proceedings are null and void.

A. The Rules of Criminal Procedure Must Be Read and Considered Together.

Arraignment and pleas have always been one of the safeguards of criminal procedure and could not be eliminated even by rules. Therefore the judgments were null and void.

Due process was not complied with in accordance with a Rule of Criminal Procedure covering criminal matters which requires an arraignment, plea and customary procedures consistent with criminal cases.

B. Appellants Were Denied a Trial in the Full Sense of the Term.

Although the court below purportedly accorded to appellants a "trial" as required by law, no trial in the true sense of that term was in fact had.

As we have stated the trial court, upon the filing of the Information in this case, issued an order to show cause as to why appellants should not be adjudged guilty of criminal contempt [R. 17].

On December 8, 1947, a hearing was held upon that order. At this hearing, the Government introduced evidence in the form of exhibits, including a stipulation of facts as to each of the counts of the Information [R. 46-55, 18-20].

The Government attorney stated that he thought the trial would be "obviated" by the stipulation [R. 46].

The court considered the documentary evidence and a stipulation of facts, and concluded that appellants had not purged themselves of contempt, and ordered that a trial be held [R. 53]. December 19 was then agreed upon as the trial date, whereupon the court indicated that it "would like an opportunity to study this evidence that has been presented, before proceedings here" [R. 54].

Then the court stated:

"I assume that what has been offered and received here, the exhibits, including the stipulation, represents the return to this order to show cause and may be deemed in evidence upon the trial; is that right?"

The court stated finally:

"The evidence introduced here this afternoon will be part of the evidence upon the trial now set for December 19th at 10:00 o'clock."

On December 19 the "trial" was held [R. 55 ff.].

The Government's case, when presented, comprising less than twenty lines in the record [R. 55-56], consisted solely of the introduction of the documents previously received in evidence at the show-cause hearing [R. 55-56]. Appellant Colgrove then testified on behalf of himself [R. 56-66].

The injunctions were not introduced in evidence, nor were the documents or evidence upon which the injunctions were based.

A criminal contempt proceeding is not part of the original cause. (*Gompers v. Bucks Stove & Range Co.*, 221 U. S. 418, 445, 446.) Nothing in the original cause was part of the record in the criminal contempt proceeding below.

Proof of criminal intent and wilfulness are wholly lacking from the Government's case thus made. Likewise absent is any proof of insufficiency of labeling under the Act.

Moreover, this "evidence" the court had already accepted at the hearing upon the show-cause order, in which it had concluded that appellants had not "purged" themselves of contempt.

There was plainly no trial here, since all that the court did was to go through formalities representative of a trial, but to which the court in fact must have come, since it knew the evidence, with a preconceived conclusion as to appellants' guilt, and a preview and preliminary study of all the "evidence" in the case.

In fact, counsel for the Government stated that he did not feel that lengthy argument was necessary because "I know that your honor * * * has had the opportunity to study the file and has heard the matter without a jury" [R. 66].

Manifestly the December 19th proceeding did not rise to the dignity of a trial as guaranteed by the laws and the Constitution of the United States.

What the Judge should have done, we submit, was to refer the matter for trial to another Judge of the court, and not try the cause himself, especially since the court had already heard the evidence against appellants and had, at the show-cause hearing, reached a conclusion adverse to them on the merits, prior to the trial below.

C. The District Court Had No Jurisdiction to Enter the Judgment in This Case Since the Judgment Is Based Both Upon Alleged Contempts and Upon Alleged Violations of Law in the Commission of "Offenses."

The judgment entered against appellants by the court below recites that they were convicted of "the offenses" of having, on given dates, "shipped in interstate commerce a product which failed to bear specific directions for the use of the product" [R. 36]. The judgment is also simultaneously based upon a conviction of appellants of having acted "in disregard of the injunctions" previously issued by that court [*id.*].

Manifestly the court below had no jurisdiction in this case to enter any judgment based upon any alleged commission of an "offense" in the shipment in interstate commerce of any articles prohibited under the food and drug law. To reach and convict a person of such an offense, a criminal proceeding was required, with all the formalities of an indictment or an information, an arraignment, pleas, setting for trial, and a full criminal trial. None were present here.

The "Information re Contempt (Criminal)" issued by the United States Attorney in this case is an instrument which purports to inform the court of the alleged acts upon which criminal contempt proceedings and findings are sought to be predicated, but at the same time the document is couched in terms present in criminal informations. It states in part that "the United States Attorney Charges," and contains nine separate "counts." Each "count," however, concludes with an allegation of criminal contempt, and the entire document ends with a "Wherefore" clause, seeking an order to show cause [R. 15].

Appellants in this case could not tell with any degree of certainty whether they were being charged with the commission of nine separate crimes by this instrument, or called upon to answer allegations of criminal contempt. They certainly were entitled to greater certainty in the charges. (See, e. g., *United States v. Cruikshank*, 92 U. S. 542, 23 L. Ed. 588.)

Then, since the "Information" in the case and the proceedings that followed it did not conform to the requirements of criminal proceeding, no finding of the commission of "offenses" in violation of the Act, and no conviction of any offenses could be made by the trial court.

The judgment below is thus defective and beyond the jurisdiction of the court below upon the proceedings before it, and should be set aside.

POINT VI.

There Can Be No More Than One Count for Contempt.

In *Carter v. U. S.*, 135 F. 2d 858 (C. C. A. 5), a sentence of both fine and imprisonment was imposed. The court took cognizance of the fact that the statute provided for punishment in the alternative, even though not assigned as error, and said:

"It is true that the evidence discloses more than one act of contempt and if two acts had been separately prosecuted and guilt found as to each, one of them might have been punished by fine and one by imprisonment. * * * (Citing the Hoffman case, *supra*.) But here there was only one general charge of contempt, one verdict of guilty, and one judgment.
* * *"

The judgment was reversed and sent back to the District Court for further proceedings. This case followed the case of

In re Bradley, 318 U. S. 50, where the Supreme Court discharged the petitioner from custody of the imprisonment portion of a judgment for contempt on the ground that having been both fined and imprisoned when the statute provided but for one or the other, and the fine having been paid, the defendant was entitled to his release.

And in *Rapp v. U. S.*, 146 F. 2d 548, the Circuit Court of Appeals for the Ninth Circuit affirmed a judgment convicting the appellant of six counts of contempt in charging and receiving rents in excess of the ceiling from six different tenants.

See also *Hoffman v. U. S.*, 13 F. 2d 278, holding similarly.

In *People v. Stephens*, 79 Cal. 428, it is said:

“The essential element of the offense was the same act in both cases. In *Regina v. Erlington*, 9 Cox C. C. 86, Cockburn, C. J., said: ‘It is a fundamental rule of law that out of the same facts a series of charges shall not be preferred.’

Bishop says: ‘To give our constitutional provision the force evidently meant, and to render it effective, “the same offense” must be interpreted as equivalent to the same criminal act.’ (1 Bishop’s Crim. L. 1060.) ‘The state cannot split up one crime and prosecute it in parts. A prosecution for any part of a single crime bars any further prosecution based upon the whole or a part of the same crime.’ (*Jackson v. State*, 14 Ind. 327.)”

POINT VII.

The Sentences Were Excessive.

The sentences in this case were clearly excessive.

As we have demonstrated above, the injunction, even if it were within the power of the court below to issue, was ambiguous to the point that the court itself stated that appellants obeyed it as written, but not in its spirit.

Conclusion.

The court was without jurisdiction to issue the order; newspaper advertising is not forbidden by the statute; the procedure and proceeding was null and void; the evidence was insufficient to support the verdicts and judgments of the court; the judgments were excessive and beyond the jurisdiction of the court. THEREFORE, they should be reversed and set aside, with directions to dismiss the case.

Respectfully submitted,

MORRIS LAVINE,

Attorney for Appellants.

No. 11832

IN THE

**United States Court of Appeals
FOR THE NINTH CIRCUIT**

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of COLUSA REMEDY COMPANY, and COLUSA REMEDY COMPANY, a corporation,
Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

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TOPICAL INDEX

| | PAGE |
|---|------|
| I. | |
| Statement of jurisdiction..... | 1 |
| II. | |
| Statutory provisions involved..... | 2 |
| III. | |
| Statement of the facts..... | 5 |
| IV. | |
| Questions involved | 11 |
| V. | |
| Argument | 12 |
| A. Most of appellants' brief deals with points not included in their assignment of errors..... | 13 |
| B. The preliminary and the permanent injunctions issued by the District Court are valid..... | 14 |
| 1. Review of an injunction in a collateral proceeding, as here, is restricted to the question of whether the District Court had jurisdiction over the parties and subject matter | 14 |
| 2. The District Court properly construed the Federal Food, Drug and Cosmetic Act in issuing the injunc- tions herein involved..... | 19 |
| C. Defendants violated both the letter and the spirit of the injunctions | 24 |
| D. Defendants were not deprived of any procedural rights in the contempt proceedings..... | 30 |
| E. The sentences imposed were not excessive..... | 35 |
| VI. | |
| Conclusion | 37 |

TABLE OF AUTHORITIES CITED

| CASES | PAGE |
|--|----------|
| Arner Co., Inc. v. United States, 142 F. 2d 730; cert. den. 323 U. S. 730..... | 20 |
| Beauchamp v. United States, 76 F. 2d 663..... | 14 |
| Bradley v. United States, 264 Fed. 79..... | 27 |
| Clarke v. Federal Trade Commission, 128 F. 2d 542..... | 14 |
| Colgrove et al. v. Lowe et al., 343 Ill. 360, 175 N. E. 569; cert. den. 284 U. S. 639..... | 36 |
| Creekmore v. United States, 237 Fed. 743; cert. den. 242 U. S. 646 | 35 |
| Empire Oil & Gas Corporation et al. v. United States, 136 F. 2d 868 | 6, 7 |
| Garland v. State of Washington, 232 U. S. 642..... | 31 |
| Hoffman v. United States, 13 F. 2d 278..... | 34 |
| Libby, McNeill & Libby v. United States, 148 F. 2d 71, foot-note 3 | 6 |
| Lustgarten v. Felt & Tarrant Mfg. Co., 92 F. 2d 277..... | 28 |
| McDermott v. Wisconsin, 228 U. S. 115,..... | 20 |
| Oates v. United States, 233 Fed. 201; cert. den. 242 U. S. 632.... | 35 |
| Rapp v. United States, 146 F. 2d 548..... | 34 |
| Research Laboratories, Inc. v. United States, 167 F. 2d 410...21, 22 | |
| Rodgers v. Pitt, 89 Fed. 424..... | 29 |
| Swift & Co. v. United States, 276 U. S. 311..... | 16, 17 |
| Terminal Railroad Association of St. Louis v. United States, 266 U. S. 17..... | 28 |
| United States v. Antikamnia Chemical Co., 231 U. S. 654..... | 21 |
| United States v. Dean Rubber Mfg. Co., 72 Fed. Supp. 819..... | 34 |
| United States v. Dotterweich, 320 U. S. 277..... | 21 |
| United States v. John J. Fulton, 33 F. 2d 506..... | 25 |
| United States v. 9 Bottles . . . Colusa Natural Oil, 78 Fed. Supp. 721 | 6, 7, 12 |

| | PAGE |
|---|------------------------|
| United States v. United Mine Workers of America, 330 U. S. 258..... | 15, 17, 18, 30, 31, 35 |
| United States ex rel. Brown v. Lederer, 140 F. 2d 136; cert. den. 322 U. S. 734..... | 35 |
| Western Fruit Growers v. Gotfried, 136 F. 2d 98..... | 14 |
| William v. Bradley, In re, 318 U. S. 50..... | 34 |

STATUTES.

| | |
|--|-------|
| Clayton Act (28 U. S. C., Sec. 387)..... | 34 |
| Code of Federal Regulations, Title 21, Sec. 2.106(a), Cumula- tive Supp., p. 5224; amended 1946 Supp., p. 2952..... | 18 |
| Code of Federal Regulations, Title 21, Cumulative Supp., p. 5224; amended, 1946 Supp., p. 2952..... | 4 |
| Drug and Device Notices of Judgment, No. 1040..... | 7 |
| Drug and Device Notices of Judgment, Nos. 1384, 2087 (issued by Fed. Security Administrator)..... | 6 |
| Federal Food, Drug and Cosmetic Act, Sec. 302(b) (21 U. S. C., Sec. 332(b))..... | 34 |
| Federal Food, Drug and Cosmetic Act, Sec. 502 (21 U. S. C., Sec. 352) | 19 |
| Federal Food, Drug and Cosmetic Act, Sec. 502(f)(1) (21 U. S. C., Sec. 352(f)(1)..... | 21 |
| Federal Rules of Criminal Procedure, Rule 37(a)(1)..... | 13 |
| Federal Rules of Criminal Procedure, Rule 42..... | 31 |
| House Report No. 2139 (75th Cong., 3d Sess.), p. 8..... | 19 |
| United States Code, Title 21, Sec. 321(g)(2)..... | 12 |
| United States Code, Title 21, Sec. 331(a)..... | 18 |
| United States Code, Title 21, Sec. 332(a)..... | 18 |
| United States Code, Title 21, Sec. 332(b)..... | 1, 34 |
| United States Code, Title 21, Sec. 334(a)..... | 22 |
| United States Code, Title 21, Sec. 375(a)..... | 6 |

| | |
|--|---------------|
| United States Code, Title 21, Sec. 352(a)..... | 12 |
| United States Code, Title 21, Sec. 352(f)(1)..... | 8, 12, 18, 23 |
| United States Code, Title 21, Sec. 371(a)..... | 18 |
| United States Code, Title 28, Sec. 225(a), (d)..... | 1 |
| United States Code, Title 28, Sec. 385..... | 1, 34, 35 |
| United States Code, Title 28, Sec. 387..... | 1 |
| United States Court of Appeals Rules on Criminal Appeals, Rule 2(d) | 13 |

No. 11832

IN THE

United States Court of Appeals FOR THE NINTH CIRCUIT

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of COLUSA REMEDY COMPANY, and COLUSA REMEDY COMPANY, a corporation,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S BRIEF.

I.

Statement of Jurisdiction.

The District Court had jurisdiction to try the defendants pursuant to Title 21, U. S. C., Section 332(b), and Title 28, U. S. C., Sections 385 and 387.

Under Title 28, U. S. C., Sections 225 (a) and (d), this Court has authority to review the judgments of the District Court.

II.
Statutory Provisions Involved.

Federal Food, Drug, and Cosmetic Act.

“Section 301. Prohibited acts [21 U. S. C. 331.]

The following acts and the causing thereof are hereby prohibited:

(a) The introduction or delivery for introduction into interstate commerce of . . . drug . . . that is misbranded.”

“Section 201. Definitions; generally. [21 U. S. C. 321.]

For the purposes of this chapter—

(g) The term ‘drug’ means . . . (2) articles intended for use in the diagnosis, cure, mitigation, treatment, or prevention of disease in man or other animals . . .”

“Section 502. Misbranded drugs and devices. [21 U. S. C. 352.]

A drug shall be deemed to be misbranded—

(a) If its labeling is false or misleading in any particular.

• • • • •

(f) Unless its labeling bears (1) adequate directions for use; and (2) such adequate warnings against use in those pathological conditions or by children where its use may be dangerous to health, or against unsafe dosage or methods or duration of administration or application, in such manner and form, as are necessary for the protection of users . . .”

“Section 302. Injunction proceedings—Jurisdiction of courts. [21 U. S. C. 332.]

- (a) The district courts of the United States . . . shall have jurisdiction, for cause shown . . . to restrain violations of section 301 [21 U. S. C. 331] . . .
- (b) In case of violation of an injunction or restraining order issued under this section, which also constitutes a violation of this chapter, trial shall be by court, or upon demand of the accused, by a jury. Such trial shall be conducted in accordance with the practice and procedure applicable in the case of proceedings subject to the provisions of section 387 of Title 28, as amended.”

Other Statutes Relating to Criminal Contempt.

Title 28, U. S. C.

“Section 385. Administration of oaths; contempts.

The courts of the United States shall have power . . . to punish, by fine or imprisonment, at the discretion of the court, contempts of their authority. Such power to punish contempts shall not be construed to extend to any cases except . . . the disobedience . . . by any party . . . to any lawful writ, process, order, rule, decree, or command of the said courts.”

Federal Rules of Criminal Procedure.

“Rule 42. Criminal Contempt.

• • • • •
(b) Disposition Upon Notice and Hearing. A criminal contempt except as provided in subdivision (a) of this rule shall be prosecuted on notice. The notice shall state the time and place of hearing, allow-

ing a reasonable time for the preparation of the defense, and shall state the essential facts constituting the criminal contempt charged and describe it as such. The notice shall be given orally by the judge in open court in the presence of the defendant or, on application of the United States attorney or of an attorney appointed by the court for that purpose, by an order to show cause or an order of arrest. The defendant is entitled to a trial by jury in any case in which an act of Congress so provides. He is entitled to admission to bail as provided in these rules. If the contempt charge involves disrespect to or criticism of a judge, that judge is disqualified from presiding at the trial or hearing except with the defendant's consent. Upon a verdict or finding of guilt the court shall enter an order fixing the punishment."

Regulations Promulgated by Federal Security Administrator.

Title 21, Code of Federal Regulations, Cumulative Supplement, page 5224, as amended by 1946 Supplement, page 2952.

"§2.106. Drugs and devices; directions for use.

(a) Directions for use may be inadequate by reason (among other reasons) of omission, in whole or in part, or incorrect specification of:

(1) Directions for use in all conditions for which such drug or device is prescribed, recommended, or suggested in its labeling, or in its advertising disseminated or sponsored by or on behalf of its manufacturer or packer, or in such other conditions, if any there be, for which such drug or device is commonly and effectively used;

- (2) Quantity of dose (including quantities for persons of different ages and different physical conditions);
- (3) Frequency of administration or application;
- (4) Duration of administration or application;
- (5) Time of administration or application (in relation to time of meals, time of onset of symptoms, or other time factor);
- (6) Route or method of administration or application; or
- (7) Preparation for use (shaking, dilution, adjustment of temperature, or other manipulation or process)."

III.

Statement of the Facts.

In order that this Court may consider this case in its proper setting, it is necessary to outline the history of defendants' operations as they appear in the Record and in other sources which the Court may judicially notice.

For a number of years, defendants have been marketing two products on an extensive national scale, one labeled Colusa Natural Oil, and the other designated as Colusa Natural Oil in capsules. [R. 59-60; see also R. 31-32 (part of Def. Ex. A) enumerating 58 newspapers in which the products have been advertised.]

The labeling of these products declares that they consist of a natural unrefined petroleum oil. [R. 22.] Throughout the years, defendants have been offering this oil to the public as beneficial and efficacious in the treatment and cure of a variety of skin diseases including psoriasis, eczema, poison ivy, poison oak, athlete's foot,

leg ulcers, acne, itch, open sores, burns, cuts, ringworm, varicose ulcers, bed sores, piles, and scaly red face. [R. 20, Pl. Ex. 1; *Empire Oil & Gas Corporation et al. v. United States*, 136 F. 2d 868, 869 (C. C. A. 9, 1943).]

Investigations and controlled clinical studies have demonstrated that Colusa Natural Oil in capsules or otherwise is simply crude oil and worthless in the treatment of the skin diseases for which it was offered, and may under some circumstances even produce a harmful effect. (*United States v. 9 Bottles . . . "Colusa Natural Oil,"* 78 Fed. Supp. 721 (N. D. Iowa, Nov. 26, 1947).)

To prevent continued marketing of this oil, the Government has successfully resorted to many-pronged action under the Federal Food, Drug, and Cosmetic Act including seizure, criminal prosecution, injunction, and criminal contempt.

Since 1940, the District Courts in practically every judicial district have effected large scale seizures and condemnations of these products wherever they could be found. (See *Drugs and Devices Notices of Judgment* issued by the Federal Security Administrator pursuant to 21 U. S. C., 375(a), especially Nos. 1384 and 2087 which alone comprise 110 different actions.)¹ Most of these actions resulted in condemnation by default. A group of such consolidated seizure actions was recently tried in the Northern District of Iowa and resulted in the Court's condemning the products and unequivocally declaring their worthlessness for the disease conditions for which they were then offered in their labeling, namely, psoriasis,

¹Judicial notice has been taken of such Notices of Judgment in *Libby, McNeill & Libby v. United States*, 148 F. 2d 71, 73, footnote 3 (C. C. A. 2, 1945).

eczema, athlete's foot, and leg ulcers. (*United States v. 9 Bottles . . . "Colusa Natural Oil," supra.*) Colusa Remedy Company has noted an appeal in that case but at this writing has not yet perfected it.

In the meantime, seizure action alone having proved ineffective to compel defendants to desist from misbranding their products, the United States had proceeded in 1942 by way of criminal prosecution in the Northern District of California against defendant Chester Walker Colgrove and the Empire Oil and Gas Company. (The latter company, controlled by defendant Colgrove, was subsequently metamorphosed into Colusa Remedy Co. by said defendant.) There the issue was whether the labeling of the oil was false or misleading in representing it as useful in the treatment of eczema, psoriasis, acne, ringworm, athlete's foot, burns, cuts, poison ivy, and poison oak. After a jury trial, defendants were convicted. This Court reversed on the ground that a witness produced by defendants was competent to answer certain questions ruled out by the trial court. (*Empire Oil & Gas Corp. et al. v. United States, supra.*) Upon remand, defendants pleaded *nolo contendere*. Defendant Colgrove was fined \$1500 and the defendant corporation was fined \$3. In addition, defendant Colgrove was sentenced to 6 months in jail, such sentence to terminate on the payment of the fine. (*Drug and Device Notice of Judgment No. 1040.*)

Apparently, fines and continuous confiscation of merchandise were insufficient to cause defendants to discontinue a lucrative interstate business. [R. 59.] As a result of their search for a loophole in the law [R. 59, 61-63], they changed the labeling of their products so that in 1945 the labeling failed to mention *any* disease conditions for which the products were offered. [Pl. Ex. 3, R. 23.] The

new promotional line was for the defendants to proclaim the alleged remarkable attributes of their products in large newspaper advertisements throughout the country. [R. 59, Pl. Ex. 1, R. 21.]

Theretofore, enforcement actions had been based upon the charge that the oil was misbranded because its *labeling* bore false and misleading therapeutic claims in violation of 21 U. S. C. 352(a). Defendants' therapeutic claims were now confined to *newspaper advertising*.

However, under 21 U. S. C., 352(f)(1), a drug is deemed misbranded if its *labeling* fails to bear adequate directions for use. Upon Complaint by the United States, the District Court for the Southern District of California found that the new *labeling* utilized by defendants failed to bear adequate directions for use in the conditions for which it was prescribed, recommended, and suggested in defendants' advertising. The Court then issued a preliminary injunction on February 24, 1947, restraining the defendants from shipping their oil interstate

"without a label containing specific directions for the use of such product in the treatment of all conditions, ills and diseases for which such product is prescribed, recommended, and suggested, in the advertising material disseminated or sponsored by or on behalf of the defendants or either of them; which directions shall include the quantity of the dose (including quantities for different ages and different physical conditions) to be taken or applied in the treatment of each of such conditions, ills and diseases, as well as the recommended frequency and duration of administration or application of such dosage."

On April 23, 1947, with the written and signed consent of the defendants, the Court issued a permanent injunction using the identical language quoted above, except that the words "adequate directions" were substituted for the words "specific directions." [R. 2, 3; Pl. Ex. 4, R. 23-24.]

Defendants understood the requirement of the injunctions that the labels on their products had to state the disease conditions for which they were offered in the advertising. [R. 59.] They devised a new label which stated that the Colusa Natural Oil was "intended for use in treatment of Psoriasis, Eczema, Athlete's Foot and Leg Ulcers" [R. 22], whereas their previous label had mentioned no disease conditions at all. [R. 23.]

Defendants then changed their advertising to highlight the same four disease conditions which they now listed in their new label, namely, psoriasis, eczema, athlete's foot, and leg ulcers. [Pl. Ex. 1, R. 20.] However, the body of the advertising continued as before to give glowing reports of benefits derived in these and eight other conditions. [Pl. Ex. 1, R. 20.] Thus, under the heading "SUMMARY OF CLINICAL REPORTS ON 28 CASES," there is a quotation of a report allegedly from a Texas doctor that with this oil he had completely cured patients suffering from psoriasis, eczema, leg ulcers, athlete's foot, and poison ivy or oak.

Similarly, under the heading "THOUSANDS OF DOCTORS ARE COLUSA CUSTOMERS—EXCERPTS FROM A FEW OF THEIR REPORTS," there are alleged quotations describing cures in the following diseases: eczema, poison ivy, athlete's foot, leg ulcers, bed sore, burns, psoriasis, acne, ringworm.

Under the heading "EXCERPTS FROM REPORTS BY DRUGGISTS," preceded by the statement "Druggists in 17 states report 89 stubborn cases where Colusa succeeded after other medicines and doctoring failed," there are reports of cures of eczema, athlete's foot, *scaly red face*, psoriasis, *acne*.

A final heading "THOUSANDS OF USERS WRITE LETTERS OF PRAISE" includes an alleged quotation from a testimonial writer that he had been cured of *itch*.

Counts 1-8 of the instant Criminal Contempt Information are based upon eight different interstate shipments of Colusa Natural Oil bearing the new label recommending the drug for psoriasis, eczema, athlete's foot, and leg ulcers. In conjunction with these shipments, defendants launched an extensive nationwide advertising campaign specifically directing prospective customers to the drug stores that were the consignees of these shipments. These facts are set forth in the Criminal Information, and stipulated to as correct. [R. 2-14, 23-24, 31-2.] As pointed out, the advertising [Pl. Ex. 1, R. 20] held out unequivocal promise of benefit not only in the treatment and cure of psoriasis, eczema, athlete's foot and leg ulcers (the diseases mentioned on the new label), *but also* in the treatment and cure of poison ivy, poison oak, bed sore, burns, acne, ringworm, scaly red face, and itch diseases *not* mentioned on the new label.

Defendants waived their right to a jury trial and to special findings of fact. [R. 25.] After full trial before the Court, defendants were found guilty of criminal con-

tempt as charged in Counts 1-8, and not guilty as to Count 9. [R. 78-79.]

Defendant Colusa Remedy Company was sentenced to pay fines totalling \$5000. [R. 35.] Defendant Chester Walker Colgrove was sentenced to pay fines totalling \$4000. He was also sentenced to imprisonment for four six-month terms to run consecutively. Execution of all sentences as to defendant Colgrove was suspended for a probationary period of five years, one of the terms of probation being payment of the \$4000 fine in installments. [R. 36-38.]

IV.

Questions Involved.

- (1) Did the District Court have jurisdiction to issue the preliminary and permanent injunctions?
- (2) Is there substantial evidence to support the District Court's judgments holding the defendants guilty of criminal contempt on Counts 1-8 of the Information?
- (3) Were defendants deprived of any procedural rights in the contempt proceedings?
- (4) If defendants are adjudged guilty of criminal contempt on eight different counts involving eight separate contumacious acts, may the District Court impose a separate sentence of either fine or imprisonment on each of such counts?

V.

ARGUMENT.

From the factual background of this case, it is obvious that the defendants, over the course of the years, have demonstrated considerable ingenuity in their search for a means to circumvent and nullify the Federal Food, Drug, and Cosmetic Act. They have been steadfast in their objective of continuing to make extravagant and baseless therapeutic claims for their Colusa Natural Oil to a gullible segment of the public.²

The Government's theory in its enforcement actions against the defendants under the Federal Food, Drug, and Cosmetic Act is divided into two parts. (1) If the labeling of the oil conveys the impression that the oil is therapeutically useful in the treatment of specifically enumerated disease conditions, then, since the oil is worthless, the labeling is false and misleading in violation of 21 U. S. C. 352(a) *United States v. 9 Bottles . . .*; "Colusa Natural Oil," *supra*. (2) If the labeling fails to state any disease conditions for which the oil is offered—the oil being a drug within 21 U. S. C. 321(g)(2) because it is intended for use in the treatment and cure of disease conditions as evidenced by claims in its advertising—then the labeling fails to bear adequate directions for use in violation of 21 U. S. C. 352(f)(1), since it fails to state essential information—*e. g.*, the disease conditions for which it is offered. We will discuss this point at greater length later in the brief.

²Even now, the story recited above is not finished. Still another injunction proceeding is now pending in the Southern District of California (No. 8572 O'C Civil) to prevent further interstate shipments of the same products with yet a new label.

A. Most of Appellants' Brief Deals With Points Not Included in Their Assignment of Errors.

Rule 2(d) of this Court's rules relating to criminal appeals declares that "errors not assigned according to this rule will be disregarded, but the Court, at its option, may notice a plain error not assigned."

Appellants' assignment of errors is its statement of "Points Upon Which Appellant Intends to Rely Upon Appeal." [R. 82-84.] That statement enumerates nine alleged errors of the District Court.

In their brief, however, appellants argue seven points, five of which are not included in their assignment of errors. The five points thus argued are (1) The Original Order of the District Court of the United States Was Not a Valid Order (App. Br. pp. 10-17); (2) The Injunction of the Court Below Was Beyond Its Powers Under the Food and Drug Act (App. Br. pp. 17-19); (3) The Attempt to Control Newspaper Advertising by Injunction Is Contrary to the Constitution of the United States (App. Br. pp. 20-23); (4) There Can Be No More Than One Count for Contempt (App. Br. pp. 34-35); (5) The Sentences Were Excessive (App. Br. p. 36).

Under Rule 37(a)(1) of the Federal Rules of Criminal Procedure, it appears that assignments of error are now abolished. However, appellants did file an assignment of errors and it was upon the basis of that assignment that the Government agreed to having the record printed in its present restricted form, eliminating therefrom a considerable amount of material bearing upon the sentence to be imposed upon defendants and made a part of the record before the District Court at the time of sentencing.

B. The Preliminary and the Permanent Injunctions Issued by the District Court Are Valid.

The permanent injunction in this case was issued by the District Court upon written consent of the appellants. No appeal was taken and no attempt was made by the appellants to modify the injunction or to correct any alleged error therein. Appellants having been convicted of criminal contempt for disobeying the conditions of the preliminary and permanent injunctions, now seek to attack the validity of these injunctions collaterally.

1. REVIEW OF AN INJUNCTION IN A COLLATERAL PROCEEDING, AS HERE, IS RESTRICTED TO THE QUESTION OF WHETHER THE DISTRICT COURT HAD JURISDICTION OVER THE PARTIES AND SUBJECT MATTER.

It is settled that alleged errors in an injunction "must be corrected by appeal and not by disobedience." *Clarke v. Federal Trade Commission*, 128 F. 2d 542, 543 (C. C. A. 9, 1942).

Of course, if an order is void because issued by a court without jurisdiction of the subject matter or parties litigant, disobedience thereof is not a criminal contempt. *Beauchamp v. United States*, 76 F. 2d 663, 668 (C. C. A. 9, 1935). As we shall point out, there is no doubt that in the instant case the District Court had complete jurisdiction over the parties and subject matter in issuing the injunctions. This being so, the injunctions should have been obeyed, for as this Court said in *Western Fruit Growers v. Gotfried*, 136 F. 2d 98, 100 (C. C. A. 9, 1943):

". . . if a court has jurisdiction over both the parties and the subject matter, an order must be obeyed so long as it remains the order of the court."

In *United States v. United Mine Workers of America*, 330 U. S. 258 (1947), the Supreme Court narrowly defined the permissible scope of collateral attack on an injunction in a criminal and civil contempt proceeding based upon violation of the injunction. Even the unconstitutionality of the underlying statute does not authorize violation of an injunction nor protect the violator. On page 293 the Court said:

“. . . an order issued by a court with jurisdiction over the subject matter and person must be obeyed by the parties until it is reversed by orderly and proper proceedings. *This is true without regard even for the constitutionality of the Act under which the order is issued.* In *Howat v. Kansas*, 258 U. S. 181, 189-90 (1922), this Court said:

‘An injunction duly issuing out of a court of general jurisdiction with equity powers upon pleadings properly invoking its action, and served upon persons made parties therein and within the jurisdiction, must be obeyed by them however erroneous the action of the court may be, even if the error be in the assumption of the validity of a seeming but void law going to the merits of the case. *It is for the court of first instance to determine the question of the validity of the law, and until its decision is reversed for error by orderly review, either by itself or by a higher court, its orders based upon its decisions are to be respected, and disobedience of them is contempt of its lawful authority, to be punished.’* (Emphasis added.)

As we have mentioned, no appeal was taken from the consent decree of injunction issued in the instant case. The fact that the permanent injunction here was entered by consent has special significance in restricting further the scope of collateral attack. This was emphasized by the Supreme Court in *Swift & Co. v. United States*, 276 U. S. 311, 324 (1928), where defendants were seeking by a collateral proceeding to vacate a consent decree of injunction:

“But ‘a decree, which appears by the record to have been rendered by consent, is always affirmed, without considering the merits of the case.’ . . . Where, as here, the attack is not by appeal or by bill of review, but by a motion to vacate, filed more than four years after the entry of the decree, the scope of the inquiry may be even narrower.”

Defendants in the *Swift* case also argued, as do appellants here (App. Br. pp. 15-17), that the decree was too vague and general in some of its terms. The Court said in dismissing this objection (p. 328):

“. . . the defendants by their consent lost the opportunity of raising the question on appeal.”

And on page 330, the Court, again stressing the narrow scope of collateral attack upon an injunction, declared:

“But the Court had jurisdiction of the subject matter and of the parties. And even gross error in the decree would not render it void.”

Another argument made in the *Swift* case was that the decree was void because the injunction was not limited to acts in interstate commerce. Appellants here make a similar argument in asserting that the issuance of the injunction was beyond the District Court’s power under

the Food and Drug Act in that it assertedly encompassed more in its decree than the statute authorizes. (App. Br. pp. 17-19.) Assuming *arguendo* that this were so, the Supreme Court in rejecting the similar contention made in the *Swift* case has effectively disposed of appellants' argument (p. 331):

“If the Court, in addition to enjoining acts that were admittedly *interstate*, enjoined some that were wholly *intrastate* and in no way related to the conspiracy to obstruct interstate commerce, it erred; and had the defendants not *waived such error by their consent*, they might have had it corrected on appeal. But the error, if any, does not go to the jurisdiction of the court. *The power to enjoin includes the power to enjoin too much.*” (Emphasis added.)

Appellants here, in attacking the injunctions upon which the contempt convictions are based, do not appear to challenge the fundamental jurisdiction of the District Court over the parties or over the subject matter. In somewhat confusing terms they seem to be charging that the injunction is void because (1) its scope is broader than authorized by the statute, (2) its terms are uncertain and indefinite, and (3) it violates appellants' constitutional rights. (App. Br. pp. 10-23.) *United States v. United Mine Workers*, *supra*, and *Swift & Co. v. United States*, *supra*, hereinabove cited and quoted from, establish that appellants may not properly raise these points in this collateral proceeding.

The District Court's fundamental jurisdiction over the subject matter of the injunction stems from its statutory power to restrain certain prohibited acts which are in violation of the Federal Food, Drug, and Cosmetic Act. (21

U. S. C. 332(a).) Among the acts it may restrain is the interstate shipment of a misbranded drug. (21 U. S. C. 331(a).) A drug is deemed misbranded if its labeling fails to bear adequate directions for use. (21 U. S. C. 352(f)(1).) Interpretive regulations of the Federal Security Administrator, promulgated pursuant to 21 U. S. C. 371(a), declare that directions for use are inadequate if there is an omission in whole or in part of directions for use *in all conditions* for which the drug is prescribed, recommended, or suggested in its labeling or in its advertising sponsored by its manufacturer, packer, or distributor. (§2.106(a), Title 21, *Code of Federal Regulations, Cumulative Supplement*, p. 5224, as amended by 1946 Supplement, p. 2952.) Hence, the District Court clearly had jurisdiction of the subject matter involved in the instant injunctions. And jurisdiction over the parties is conceded. [R. 3, 24.]

Furthermore, with respect to the preliminary injunction based upon a hearing and findings, there can be no doubt as to the District Court's power to issue such injunction pending final determination of the merits, and to punish violations thereof as contempt regardless of whether a permanent injunction is issued or ultimately set aside on appeal. *United States v. United Mine Workers, supra*, at 290-292. Consequently, as to the instant convictions on Counts 1, 4 and 5, which concern violations of the preliminary injunction, there is no possibility of any attack on the decree even on grounds of lack of fundamental jurisdiction.

2. THE DISTRICT COURT PROPERLY CONSTRUED THE FEDERAL FOOD, DRUG, AND COSMETIC ACT IN ISSUING THE INJUNCTIONS HERE INVOLVED.

With respect to the permanent injunction issued on consent, it has been shown that appellants may not now call upon this Court to determine the correctness of the District Court's construction of the reach of the statute. As has been demonstrated, the District Court had jurisdiction over the subject matter and the parties, the only permissible points of inquiry here with respect to the injunctions. However, we shall briefly set forth what we consider to be the rationale fully supporting the lower court's decision in issuing the injunctions.

By enacting the various subsections comprising Section 502 of the Act (21 U. S. C. 352), Congress clearly sought to develop reasonable and effective safeguards for the public in its use of drugs. The statute is affirmative in its demand that the labeling of a drug bear adequate directions for use, supplying the consumer with information essential to intelligent lay use. In House Report No. 2139, 75th Cong., 3d Session, page 8, the House Committee on Interstate and Foreign Commerce stated:

“Other provisions of section 502 are designed to require the labeling of drugs and devices *with information essential to the consumer*. The bill is not intended to restrict in any way the availability of drugs for self-medication. On the contrary, *it is intended to make self-medication safer and more effective*. For this purpose provisions are included in this section requiring the appropriate labeling of habit-forming drugs, *requiring that labels bear adequate directions for use*, and warnings against probable misuse, and setting up appropriate provisions for deteriorating drugs.” (Emphasis added.)

It is difficult to conceive of any information which could be more essential to the consumer regarding a drug which he can purchase without a physician's prescription than a statement or enumeration of the disease conditions for which the drug is to be used. Indeed, without such statement or enumeration no directions for the use of such a drug can be considered adequate under this statute.

The statutory words "adequate directions for use" cannot be construed *in vacuo*, but must be considered in relation to the information they convey to the lay public and to the efficient administration of the statute. Labeling not only serves to inform the ultimate consumer, but also performs the vital function of providing a means of determining compliance with, or violation of, the Act. *McDermott v. Wisconsin*, 228 U. S. 115, 132 (1913); *Arner Co., Inc., v. U. S.*, 142 F. 2d 730, 734 (C. C. A. 1, 1944), cert. denied 323 U. S. 730. How can the adequacy of mechanical instructions for the intake or application of a drug be ascertained for enforcement purposes except in relation to specific diseases, an enumeration of which must form an integral part of the directions for use?

How could it possibly be known whether certain directions for the use of a drug are adequate unless it is known what the drug is to be used for? Unless the statutory requirement of adequate directions for use in the labeling is a futility, the directions in the labeling must refer to the use of the drug in specifically enumerated conditions of disease and must lead to the effective use of the drug in the treatment or cure of such specified conditions. Furthermore, where a drug is offered to the public in newspaper advertising for certain disease conditions, it is no imposition upon the legitimate manufacturer to require him to state all of those conditions in the labeling.

together with directions adequate for its use in those conditions.

In *United States v. Dotterweich*, 320 U. S. 277, 280 (1943), the Supreme Court enunciated a rule of construction for this statute which is particularly appropriate here:

“The purposes of this legislation thus touch phases of the lives and health of people which, in the circumstances of modern industrialism, are largely beyond self-protection. *Regard for these purposes should infuse construction of the legislation if it is to be treated as a working instrument of Government and not merely as a collection of English words.*” (Emphasis added.)

And in *United States v. Antikamnia Chemical Co.*, 231 U. S. 654, 665, 667 (1914), a case arising under the Food and Drugs Act of 1906, which preceded the instant legislation, the Supreme Court pointed out:

“The purpose of the act is to secure the purity of food and drugs *and to inform purchasers of what they are buying.* Its provisions are directed to that purpose and must be construed to effect it.”

* * * * *

“*The purpose of the law is the ever insistent consideration in its interpretation.*” (Emphasis added.)

See also pronouncements of this Court in *Research Laboratories, Inc., v. United States*, 167 F. 2d 410, 421 (C. C. A. 9, 1948), cert. denied U. S. (Oct. 18, 1948).

As we have shown, one of the purposes of Section 502(f)(1) (21 U. S. C. 352(f)(1)) is to assure that lay use of a drug in self-medication will be safe and efficacious

in those conditions or diseases for which the drug is offered to the public. If this section were to be interpreted as authorizing the omission from the labeling of the conditions of disease for which the drug is offered, it would result in the creation of a serious defect in the statute permitting the very mischief intended to be redressed. Any worthless drug could then use the channels of interstate commerce with impunity, not being required to come out in the open with therapeutic representations in the labeling which would of necessity be false and misleading.

On the basis of the foregoing impelling considerations, we submit that the District Court was eminently sound in its construction of the statute leading to the issuance of the injunctions challenged by appellants. Appellants' attempts to discover loopholes in the law are typical of similar efforts by other purveyors of worthless drugs. In *Research Laboratories, Inc., v. United States*, 167 F. 2d 410, 423 (C. C. A. 9, 1948), *cert. denied* U. S. (Oct. 18, 1948), this Court declared that it would best serve the public interest to keep the drug "Nue-Ovo" off of the market altogether. Even while the Court was writing this opinion, and apparently in anticipation of this decision, Research Laboratories shipped Nue-Ovo with labeling that stated no disease conditions. A seizure action under 21 U. S. C. 334(a) in the Southern District of California resulted in condemnation of the Nue-Ovo on May 13, 1948, on the ground that the labeling failed to bear adequate directions for use in that it failed to reveal the diseases or conditions for which the drug would be

effective when used as directed. (No. 7418-WM Civil.) Thus the District Court effectively complemented the decision of this Court by construing 21 U. S. C. 352(f)(1) along the lines urged by the Government here and thereby prevented nullification of this Court's ruling.

Appellants argue vigorously that the consent decree of injunction was an improper and unconstitutional attempt to control newspaper advertising. While we submit that, for the reasons previously mentioned, this point is not properly raised here, it is obvious from a mere reading of the injunctions that they *in no way regulate appellants' newspaper advertising*. Under the terms of the injunctions, appellants can say whatever they wish in their advertising. The injunctions merely require the *labeling* of their products to enumerate all of the disease conditions for which the products are offered in the advertising, together with adequate directions for their use in each of such conditions.

Violation of the injunctions resulted from appellants' referring to only *four* disease conditions in the labeling of the oil which they subsequently shipped interstate, though the advertising extolled its beneficial virtues in *twelve* disease conditions.

Thus, on the merits it is clear that the injunctions were fully authorized by the statute. In any event, however, there can be no doubt that the District Court had basic jurisdiction over the subject matter and the parties in issuing the injunctions. Under settled principles, examination of such jurisdiction, at most, is the only permissible inquiry in the present proceeding.

C. Defendants Violated Both the Letter and the Spirit of the Injunctions.

Defendant Colgrove is a graduate of a law school. [R. 65.] It is plain from the record that he understood precisely what the Court intended by the terms of the injunction. Upon issuance of the injunction, he promptly revised the label of his product to enumerate *four* disease conditions. [R. 59, 22.] He also changed the advertising so as to keep in large type only those same *four* disease conditions. [R. 59-60; Deft. Ex. B, R. 29.] But in glowing testimonial reports from clinics, doctors, druggists, and users, his advertising continued to offer the oil for *twelve* disease conditions.

In explanation, defendant Colgrove stated he had carefully analyzed the advertisement in the light of the injunction. [R. 63.] He added:

“I relied upon the common sense conclusion that I was only advertising those diseases that are in the large type, and my literal interpretation of ‘prescribed, recommended, and suggested,’ the label not carrying any specific references to those diseases [enumerated in testimonial part of the advertising] and no specific references as to the instructions as to the use for those particular conditions under those names.”

In other words, defendant Colgrove felt that as to the four disease conditions for which he offered the product in large type at the top of his advertisements, he *was* “prescribing, recommending, and suggesting” them, and it was therefore necessary that the labeling specifically refer to them. However, as to the additional *eight* disease conditions for which the product was held out as a cure in the testimonial part of the advertisement, Colgrove’s

legal training told him he was in the clear. On cross-examination he testified as follows [R. 64-65]:

"Q. But it is a fact, although deleting 'Acne' from the large print, it does appear in the testimonial part of the advertisement, is that right? A. That is true, but it is not as advertised. *Those things are psychologically cumulative and supportive. They were not definitely advertised.*

Q. Is it your position that the large type at the top of the advertisement constitutes 'prescribing, recommending, and suggesting' but that the material which appears in the rest of the advertisement does not constitute 'prescribing and suggesting'? A. *I did not prescribe for any of the material in the rest of the advertisement.* That is one of your allegations.

Q. You say you were not 'prescribing.' Were you 'recommending and suggesting' only? Is that the point? A. *I was not 'prescribing, recommending, and suggesting.' I was conforming with the decree, in my opinion, according to my literal interpretation of it.*" (Emphasis added.)

According to defendant Colgrove's dictionary studies [R. 61-62], he was not "prescribing" the oil for any remedy when he was merely quoting from excerpts of allegedly scientific reports, and letters of satisfied users. But in *United States v. John J. Fulton*, 33 F. 2d 506 (C. C. A. 9, 1929), this Court had occasion to rule upon a closely related argument. In that case, the labeling referred to testimonial letters from physicians asserting the curative value of the drugs involved in the treatment of diabetes and Bright's disease. On page 507 this Court rejected the argument in these words:

"The point of the exception is that nowhere in the label, wrapper, or attending circular does the pro-

prietor or shipper make any direct statement or representation that the drugs are of curative or therapeutic value. In each case there is the statement, ‘we have received many letters from physicians reporting,’ followed by what is represented to be the substance of such ‘reports,’ which admittedly would tend to engender a belief to persons suffering from diabetes or Bright’s disease, that the use of the drugs would likely afford them relief. Unless we discredit their mental competence, such, we must presume, was the intent and expectation of the proprietors. Their contention is that they have such letters or reports and that that fact constitutes a complete defense whatever may be the character of the drugs. But if, as is alleged, the drugs are worthless, *the proprietors cannot escape responsibility by hiding behind the phrase ‘the doctors say.’* Couched in such language undoubtedly the printed matter makes a more persuasive appeal to the credulity of sufferers from these diseases than if the representations thus implied were made directly upon the authority alone of the proprietors, and for that reason they are not less but more obnoxious to the law.” (Emphasis added.)

We submit that by deliberately including in their advertising excerpts of letters purporting to come from doctors, druggists, and users, praising the virtues of Colusa Natural Oil in the cure of twelve disease conditions, the defendants most effectively, in the words of the injunctions, “prescribed, recommended and suggested” the oil in the treatment of those twelve conditions. Having enumerated only four of those conditions in the labeling of the oil, they cannot seek refuge in the specious argument that as to the other eight conditions, they were merely quoting from doctors, druggists, and users. The defendants can-

not escape responsibility for the natural meaning conveyed *and obviously intended to be conveyed* by their paid advertising.

We think the meaning of the advertisement which was spread all over the nation can be fairly stated somewhat as follows:

“If you suffer from *any* of the diseases mentioned in this advertisement, we urge you to try Colusa Natural Oil. It has cured thousands as indicated by this mere sample of excerpts from clinical studies and reports from doctors, druggists, and satisfied users. We are so sure Colusa Natural Oil will cure you, too, *if you suffer from any of these diseases*, that we are prepared to give you your money back if it does not.”

Unless this meaning was conveyed to the reader by the advertisements, the defendants who were paying for the ads [R. 53] were making a charitable contribution to the newspapers running the ads, and the ads themselves were “a waste of printer’s ink.” *Bradley v. United States*, 264 Fed. 79, 81 (C. C. A. 5, 1920).

We do not take issue with the proposition advanced by appellants that a decree of injunction must make it clear to the affected parties what it is that they are prohibited from doing. However, the meaning of the words used in an injunction to prevent continued violation of a law is not to be ascertained solely by dictionary perusal. Rather, their meaning is to be ascertained in the light of the issues and the purposes for which the suit resulting in the injunction was brought. In *Terminal Railroad Association*

of St. Louis v. United States, 266 U. S. 17, 29 (1924), the Supreme Court made this point clear:

“In contempt proceedings for its enforcement, a decree will not be expanded by implication or intend-
ment beyond the meaning of its terms *when read in
the light of the issues and the purpose for which the
suit was brought; and the facts found must constitute
a plain violation of the decree so read.*” (Emphasis
added.)

See also:

Lustgarten v. Felt & Tarrant Mfg. Co., 92 F. 2d
277, 280 (C. C. A. 3, 1937).

It is obvious in the case at bar that the purpose for which the injunction was sought was to prevent further interstate shipments of Colusa Natural Oil unless its labeling (1) enumerated all of the disease conditions for which it was *held out* in its newspaper advertising as efficacious, and (2) bore directions adequate for the use of the oil in each of those conditions. [R. 2-3.] The words “pre-
scribed, recommended, and suggested” were employed by the Court to accomplish that objective. As shown by the excerpts from defendant Colgrove’s testimony, set out above, the Court’s purpose was well understood by Col-
grove. Nevertheless, Colgrove consciously and deliberately undertook to tear the single word “prescribe” out of its context and sought to give it an “interpretation” [R. 61-2,
65], which would enable him to continue to carry on the very activity at which the injunctions were aimed, and which would at the same time immunize him from punishment for violation of the injunctions.

Defendant manifestly set about to devise a rationaliza-
tion for a scheme to thwart the District Court’s orders.

Courts are not disposed to look with favor upon such enterprises. In *Rodgers v. Pitt*, 89 Fed. 424, 429 (C. C. Nevada, 1898), an opinion which well describes the attitude of courts generally toward this type of attempted evasion, the Court declared:

“The defendant in this case was bound to obey the injunction, and when he interfered with the court’s order, he was acting at his peril. He certainly ought not to have acted upon his own judgment as to what his rights were, when it was manifest that his acts would, at least, amount to a technical violation of the terms of the injunction. It was not for him to set up his own opinion as to the meaning and effect of the injunction. If he entertained any doubt as to what he might do without violating the injunction, he should have applied to the court for a modification of the injunction, or for the privilege of doing certain acts, which, by the advice of counsel, he claims he had a right to do.

* * * * *

“The belief, motive, or intent of the defendant not to violate the injunction does not excuse him if in fact his acts resulted in a violation of it. The breach of the injunction consists in doing the forbidden thing, and not in the intention with which it is done. * * *

* * * * *

“Courts are always disposed to allow a fair latitude of construction as to the terms of the injunction, and in many cases only require that it should be obeyed in its spirit, so that no injury should be occasioned to the complaining party. *But they are never inclined to look with any degree of indulgence on schemes which are devised to thwart their orders.* Any person who has been enjoined, who undertakes to see how

far he can go or what he may do without crossing the prohibited line, places himself in a dangerous condition, and is always liable to be deemed guilty of contempt; for his own judgment may be so warped by his feelings or necessities that he is liable, even unintentionally, to overstep the legal bounds.” (Emphasis added.)

We submit that in the instant case, defendants clearly understood the full scope of the words used by the District Court in the injunctions, and deliberately transgressed both the letter and the spirit of the Court’s mandate.

D. Defendants Were Not Deprived of Any Procedural Rights in the Contempt Proceedings.

Appellants’ Brief raises a multitude of points regarding alleged procedural defects in the proceedings below. (App. Br. 29-34.) None has merit.

(1) The allegation is made that it was not clear whether the proceeding was criminal or civil. The proceeding was instituted as an “Information *Re* Contempt (Criminal),” brought in the name of the United States, and the last paragraph of each Count in the Information specifically charges that the defendants are “in criminal contempt.” [R. 2-15.] Also, the Order to Show Cause ordered the defendants to appear and show cause why they should not be adjudged “in criminal contempt.” [R. 16.] The stipulation of facts entered into refers to “the parties to this criminal contempt action.” [R. 24.] Just how the criminal nature of this proceeding could have been made clearer is difficult to conceive. In *United States v. United Mine Workers of America, supra*, at 297, the Supreme Court held that the defendants were quite aware that a criminal contempt was charged despite the fact that the words

“criminal contempt” did not appear either in the petition or in the rule to show cause.

(2) Appellants complain that “the proceedings started out as a civil proceeding with an Order to Show Cause being issued against the defendants.” (App. Br. 29.) But Rule 42(b) of the Federal Rules of Criminal Procedure, which appellants quote (App. Br. 4-5), *expressly* authorizes the initiation of a criminal contempt proceeding by “an order to show cause.” In the *United Mine Workers* case, *supra*, at 297, the Supreme Court affirmed convictions of criminal contempt based upon a rule to show cause.

(3) Appellants assert that there was no arraignment or plea and therefore the proceedings were void. (App. Br. 29-30.) However, Rule 42 of the Federal Rules of Criminal Procedure, which prescribes the special procedure to be followed in criminal contempts, does not require arraignment and plea. Moreover, it is settled that even the total absence of an arraignment is not a fatal defect in a criminal prosecution where the accused, as here, have had sufficient notice of the accusation and an adequate opportunity to defend themselves. *Garland v. State of Washington*, 232 U. S. 642, 645 (1914.).

(4) Appellants claim they were denied a trial “in the full sense of that term.” (App. Br. 30-31.) As to adequacy of notice, there can be no question. Actually, the Criminal Information was filed on October 2, 1947 [R. 15]; the Order to Show Cause issued on October 3, 1947. [R. 16-17.] Yet hearing on the Order to Show Cause was deferred at defendants’ request until December 8, 1947. [R. 45-55.] At the hearing, the District Court found that the alleged contempt had not been sufficiently purged, and asked defendants whether they wanted a jury trial. [R. 53.] Defendants through counsel stated that

a Court trial would be satisfactory and then executed a written waiver of jury trial and special findings. [R. 53, 25.]

At the hearing on the Order to Show Cause, the Government's attorney introduced a stipulation which reads as follows [R. 46, 24]:

“STIPULATION.

It is hereby stipulated and agreed by and between the parties to this criminal contempt action:

(1) That all of the facts set forth in the Criminal Information are true, except that it is not admitted that the advertisements referred to in said Information prescribe, recommend and suggest Colusa Natural Oil in the treatment of poison ivy, poison oak, bed sores, acne, ringworm, scaly red face, burns, piles and itch.

(2) That the attached newspaper advertisement taken from page 8 of the June 12, 1947, issue of the The Ridgewood Herald-News, Ridgewood, New Jersey, and identified as Exhibit A, is typical of the advertisements referred to in said Information.

(3) That the label on the bottle of Colusa Natural Oil identified as Exhibit B is representative of the labels referred to in Counts 1-8 of the Information.

(4) That the label on the bottle of Colusa Natural Oil identified as Exhibit C is representative of the labels referred to in Count 9 of the Information.”

By express agreement of counsel at the hearing, this stipulation and the exhibits to which it referred were “deemed in evidence upon the trial.” [R. 55.]

Trial was set for December 19, 1947, a date satisfactory to defense counsel. [R. 54-55.] At the trial, defense counsel again agreed that the stipulation and exhibits would be deemed part of the record for the purpose of the trial. [R. 56.]

Appellants are in error when they state the injunctions were not introduced into evidence at the contempt trial. [R. 31.] The Criminal Information sets forth the pertinent portions of the injunctions verbatim [R. 2-3] and defendants stipulated (with one reservation not pertinent here), that "all the facts set forth in the Criminal Information are true." [R. 24.]

(5) Appellants argue that "there can be no more than one count for contempt." [R. 34.] The eight counts on which appellants were convicted are expressly based upon eight separate interstate shipments of Colusa Natural Oil, each of which was in violation of the preliminary or the permanent injunction. [R. 2-14.] The District Court, having found defendants guilty on Counts 1-8, sentenced each defendant separately on each count. [R. 34-38.] As to the individual defendant Colgrove, the Court imposed a sentence of fine *or* imprisonment on each count, execution of the imprisonment sentence being suspended during a probationary period. On no count was a sentence of both fine and imprisonment imposed.

The District Court's power to punish for contempt in this case stems from its inherent and general statutory

power contained in Title 28, Section 385,³ United States Code, to punish for contempt the disobedience by any party of any lawful decree of the Court. That provision authorizes the Courts "to punish, *by fine or imprisonment, at the discretion of the Court*, contempts of their authority."

It has been held that such a contempt is punishable either by fine or by imprisonment, but not by both. *In re William v. Bradley*, 318 U. S. 50 (1943). This was followed here.

It has also been held that where a person is convicted on a number of contempt charges, he may, as in this case, be fined on some and imprisoned on others.

Rapp v. United States, 146 F. 2d 548, 549 (C. C. A. 9, 1944);

Hoffman v. United States, 13 F. 2d 278, 279 (C. C. A. 7, 1926).

From these authorities, it is clear that defendants, having been convicted on eight different criminal contempt counts arising out of eight separate and distinct transactions, were properly subject to a *fine or imprisonment* on each count, the nature and extent of *each* such sentence being discretionary with the District Court.

³Section 302(b) of the Federal Food, Drug, and Cosmetic Act [21 U. S. C. 332(b)] declares that the trial in a criminal contempt proceeding such as the instant one shall be conducted in accordance with the practice and procedure applicable in the case of proceedings subject to 28 U. S. C. 387 (the Clayton Act). Since only the practice and procedure of the Clayton Act are adopted for the purposes of trial, the *power* of the District Court to act at all is derived from its inherent authority to punish criminal contempts, as qualified by 28 U. S. C. 385. It has already been held that only a limited portion of the Clayton Act is applicable to contempt proceedings under 21 U. S. C. 332(b). *United States v. Dean Rubber Mfg. Co.*, 72 Fed. Supp. 819 (W. D. Mo., 1947).

E. The Sentences Imposed Were Not Excessive.

Under 28 U. S. C. 385, the character and extent of punishment is entirely discretionary with the Court. *Creekmore v. United States*, 237 Fed. 743, 752 (C. C. A. 8, 1916), cert. denied 242 U. S. 646; *Oates v. United States*, 233 Fed. 201, 208 (C. C. A. 4), cert. denied 242 U. S. 632; *United States ex rel Brown v. Lederer*, 140 F. 2d 136, 139 (C. C. A. 7, 1944), cert. denied 322 U. S. 734. See also the Supreme Court's declaration in the *United Mine Workers* case, *supra*, at page 304, distinguishing between the criteria applicable in imposing sentence in civil and in criminal contempts.

At the outset of our argument in this brief, we informed this Court that the printed record does not contain certain voluminous material bearing upon the previous activities of defendants with which the District Court was familiar and which had been made part of the record below at the time sentence was imposed, the omission of which greatly shortened the printed record on appeal and thus considerably reduced the cost to appellants. This omission, was brought about by counsel's representation that he intended to raise no issue on appeal as to excessiveness of penalty.

Even without the complete record, however, it is clear from the printed record and from the other sources to which we have referred and of which this Court may take judicial notice, what considerations prompted the sentences imposed by the District Court. Obviously, the District Court was impressed by the defendants' long history of law violations, and constant scheming for ways and means

to circumvent not only the food and drug law but also other laws. See, for an example of violation of another law, *Colgrove et al. v. Lowe et al.*, 343 Ill. 360, 175 N. E. 569, cert. denied 284 U. S. 639, where an insurance scheme of defendant Colgrove was held illegal.

Furthermore, as to the defendants' ability to pay the fines assessed, Colgrove testified that the two column advertisement published from time to time in at least fifty-eight newspapers all over the country "had been a successful producer." [R. 59.] At the time of the sentencing, he also indicated the substantial revenues which had been derived from the sale of Colusa Natural Oil.

Under the circumstances, we submit that the sentences imposed by the District Court were far from excessive, and well within the limits of its discretionary power. The total fine of \$9000 represents only a fraction of the illicit profits which defendants have obtained by preying upon the gullible and the sick. Moreover, the suspended jail sentence imposed upon defendant Colgrove, is probably the most effective deterrent the Court could devise to prevent further illegal activities—short of sending the defendant to jail.

VI.
Conclusion.

We respectfully submit that the judgments of the District Court in convicting and sentencing the defendants are correct and should be affirmed.

Respectfully submitted,

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No. 11832

IN THE

**United States Court of Appeals
FOR THE NINTH CIRCUIT**

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of COLUSA REMEDY COMPANY, and COLUSA REMEDY COMPANY, a corporation,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

CLOSING AND SUPPLEMENTAL BRIEF.

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TOPICAL INDEX

| | PAGE |
|--|------|
| I. | |
| The information fails to allege wilfulness..... | 6 |
| II. | |
| The record clearly shows, without dispute, that appellants made a determined and good faith effort to comply with injunction.... | 12 |
| III. | |
| No flaunting of court's order or any willfulness proved..... | 13 |
| IV. | |
| The question here is whether newspaper advertising in testimonials constitute "labels" or come within its orbit?..... | 15 |
| V. | |
| Newspaper advertising is not "labeling." The Solicitor General so stated before the United States Supreme Court in another case | 17 |
| VI. | |
| Newspaper advertising only under control of Federal Trade Commission | 19 |
| VII. | |
| The court was without jurisdiction to make the order..... | 23 |
| VIII. | |
| There has not been the slightest showing in this case that the "directions for use" on the labels in question were not adequate for the treatment of the "omitted" diseases (poison oak, etc.) | 26 |
| Conclusion | 29 |

TABLE OF AUTHORITIES CITED

| CASES | PAGE |
|--|-----------------------|
| Agnes v. United States, 164 U. S. 36..... | 5 |
| Alberte v. United States, 159 F. 2d 278..... | 5 |
| Beauchamp v. United States, 76 F. 2d 663..... | 23, 25 |
| Fisk, Ex parte, 113 U. S. 713, 28 L. Ed. 1117..... | 23, 25 |
| Holt v. United States, 218 U. S. 245..... | 5 |
| Kordel v. United States, 93 L. Ed. (Adv.) 74..... | 17, 18 |
| Rowland, Ex parte, 104 U. S. 604, 26 L. Ed. 861..... | 23, 25 |
| Rumel v. United States, 293 Fed. 532..... | 5 |
| Sawyer, Re, 124 U. S. 200, 31 L. Ed. 402..... | 23, 25 |
| Screws v. United States, 325 U. S. 91..... | 9, 10 |
| Stein v. United States, 153 F. 2d 737..... | 11 |
| United States v. Balaban, 26 Fed. Supp. 491..... | 5 |
| United States v. Resnick, 299 U. S. 207..... | 5 |
| United States v. Urbuteit, 93 L. Ed. 79..... | 18 |
| United States of America v. United Mine Workers of America, 330 U. S. 258..... | 5, 11, 13, 23, 24, 25 |
| MISCELLANEOUS | |
| 80 Congressional Record 10230-10244 (1936), S. 5..... | 19 |
| 83 Congressional Record 391-424 (1938)..... | 19 |
| 83 Congressional Record 3287-3293 (1938)..... | 19 |
| Hearings Before the Committee on Commerce (U. S. Senate, 73d Cong., 2d Sess.) pp. 1-12, S. 2800, Sec. 2..... | 18 |
| 16 Law Weekly, p. 3108..... | 22 |
| STATUTES | |
| Federal Trade Commission Act, Sec. 12 (Pub. Law 203, 63d Cong., amended by 77th Cong., 52 Stat. 114; U. S. C. 15:42) 19 | |
| Federal Trade Commission Act, Sec. 15..... | 20 |
| United States Code, Title 28, Sec. 386..... | 4, 7, 10 |
| United States Code, Title 28, Sec. 387 | 7, 10 |

No. 11832

IN THE

United States Court of Appeals FOR THE NINTH CIRCUIT

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of COLUSA REMEDY COMPANY, and COLUSA REMEDY COMPANY, a corporation,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

CLOSING AND SUPPLEMENTAL BRIEF.

With leave of Court, plaintiff and appellant files this Closing Memorandum.

We specifically call attention to the court's language of the injunction which is as follows:

"Defendants were therein enjoined 'from introducing or delivering for introduction into interstate commerce, in any form or manner, the product known as "Colusa Natural Oil", or any like product, without a label containing specific directions for the use of such product in the treatment of all conditions, ills and diseases for which such product is *prescribed, recommended, AND suggested*, in the advertising ma-

terial disseminated or sponsored by or on behalf of the defendants or either of them; which directions shall include the quantity of the dose (including quantities for [2] persons of different ages and different physical conditions) to be taken or applied in the treatment of each of such conditions, ills and diseases, as well as the recommended frequency and duration of administration or application of such dosage.' " (Emphasis ours.) [R. 2, 3.]

The judgment of the court, however, gives the following language:

"It Is Adjudged that the defendant has been convicted upon his *plea of not guilty*, after trial by the Court without a jury, jury trial having been waived by the defendant, of the offenses of on or about April 1, 1947, May 6, 1947, July 9, 1947, April 17, 1947, April 5, 1947, May 3, 1947, April 28, 1947 and April 2, 1947, having shipped in interstate commerce a product which failed to bear specific directions for use of the product in the treatment of all ills, conditions and diseases for which the product is prescribed *or* recommended *or* suggested in the advertising material disseminated and sponsored by the defendant and Colusa Remedy Company, a Nevada corporation; and in disregard of the injunctions issued February 24, 1947 and April 23, 1947 by this Court in cause numbered 5992-WM Civil, as charged in Counts One to Eight inclusive of the information; and the Court having asked the defendant whether he has anything to say why judgment should not be pronounced, and no sufficient cause to the contrary being shown or appearing to the Court,

It Is Adjudged that the defendant is guilty as charged and convicted." [R. 36.]

It is respectfully submitted that although the injunction is in the *conjunctive*, the judgment is in the *disjunctive* and where the court's order covered the entire field, the judgment made it *disjunctive*. This alone should reverse the judgment.

Furthermore, we call attention of the Court to the language that the judge used at the time of the finding of "guilty." The Court said:

"Mr. McGann:

Now, those circumstances all point only in one direction, that this defendant in everything that he did, he acted in good faith and that he wanted to conform with this order of the court and not be in violation of it.

The Court: The defendant is technically, literally correct in the literal reading of the restraining order, that the label be required to contain specific directions for the use of the product—I am abbreviating that—in the treatment of all ills for which such product is prescribed, recommended, and suggested.

Read literally, the prohibition is against introducing into interstate commerce drugs which do not contain a label containing specific directions for its use in connection with all ills for which it is prescribed and recommended and suggested in the advertising material disseminated by the defendant.

So, literally read, it is true that in order to violate the language of this injunction it would be necessary for the advertising material to prescribe and recommend and suggest the use of the product for the treatment of a condition or an ill or a disease not referred to in the label. That, manifestly, is not the spirit of the injunction.

I think the injunction should, possibly, have been worded in the disjunctive instead of the conjunctive. It should have read 'conditions, ills, and diseases for which such product is prescribed or recommended or suggested in the advertising material,' but the manifest spirit must be read it in the disjunctive, because if the advertising material is prescribed, certainly prescription includes 'recommendation and the suggestion' and there would be no (30) meaning at all left for the words 'recommended and suggested' if the words were used alternatively. As I stated, 'prescribed' includes 'recommended and suggested.'

My view of it is that the defendant attempted to obey the words but not the spirit of the prohibition.

"With respect to Counts One to Eight, Counts One, Two, Three, Four, Five, Six, Seven and Eight, I find the defendant, Chester Walker Colgrove, guilty of contempt as charged. With respect to Count Nine of the information, I find the defendant, Chester Walker Colgrove, not guilty as charged." [R. 77, 78.]

It is therefore apparent that the Court's finding was not based upon the doctrine of *reasonable doubt*, nor any substantial evidence of *wilful* violation of the Court's decree. Section 386, Title 28, requires wilfulness to constitute Contempt of a Court decree. In an injunction case, a criminal contempt proceeding follows the same rules of evidence as in a criminal case and the evidence must be substantial and must sustain the determination

of the trier of the fact by evidence that establishes the *wilful* violation beyond a reasonable doubt. The evidence here clearly fails to do that. The pleadings also fail to allege.

United States of America v. United Mine Workers' of America, 330 U. S. 258;

Rumel v. U. S., 293 Fed. 532.

In *United States v. Balaban*, 26 Fed. Supp. 491, at 498, the court stated:

“In a proceeding for criminal contempt the presumption of innocence must be applied. The burden is on the government to prove the guilt of the defendants beyond a reasonable doubt. There is no shifting of the burden of proof. The defendants cannot be compelled to testify against themselves. *Gompers v. Buck's Stove & Range Co.*, 221 U. S. 418, 444, 31 S. Ct. 492, 55 L. Ed 797, 34 L. R. A., N. S. 874.”

“In a contempt proceeding, the Government must prove all the essential elements of the offense and guilt beyond a reasonable doubt.”

United States v. Resnick, 299 U. S. 207;

Holt v. United States, 218 U. S. 245;

Agnes v. United States, 165 U. S. 36;

Alberte v. United States, 159 F. 2d 278.

I.

The Information Fails to Allege Wilfulness.

The charging part of the information is as follows:

"That on April 1, 1947, defendants shipped from Los Angeles, California, to said Schlitz Bros. Drug, Appleton, Wisconsin, a consignment of Colusa Natural Oil which bore labels reading in part as follows:

'A natural unrefined petroleum oil intended for use in the treatment of Psoriasis, Eczema, Athlete's Foot, and Leg Ulcers.

'Directions: Apply to affected parts and rub it in thoroughly morning and night. For open sores, saturate cotton pad with oil and bind on by gauze. Change to fresh dressing morning and night. For tender skin oil can be diluted 50% with olive oil. Continue treatment until skin is smooth and comfortable . . . '

That the advertisements alluded to in defendants' letter of April 2, 1947, appeared on April 24 and June 4, 1947 in the Appleton Post-Crescent, Appleton, Wisconsin, giving the name and address of Colusa Remedy Company and Schlitz Bros. Drug.

Said advertisements prescribe, recommend, and suggest Colusa Natural Oil as highly efficacious not only for psoriasis, athlete's foot, eczema, and leg ulcers (the four disease conditions mentioned on the label of said drug) *but also* for poison ivy, poison oak, bed sores, acne, ring-worm, scaly red face, burns, piles, and itch.

That the labels on defendants' product, as shipped to said Schlitz Bros. Drug, on April 1, 1947, disregarded the requirements of the aforesaid preliminary injunction since they fail even to attempt to bear specific directions for use of the product in the treat-

ment of all ills, conditions, and diseases for which the product is prescribed, recommended and suggested in the advertising material disseminated and sponsored by the defendants.

That by reason of the said shipment of April 1, 1947, the defendants are in criminal contempt of the preliminary injunction issued by this Court as aforesaid." [R. 4, 5.]

Title 28, Section 386, as it existed at the time of the alleged offenses, is as follows:

"§386. Contempts; when constituting also criminal offense. Any person who shall *willfully* disobey any lawful writ, process, order, rule, decree, or command of any district court of the United States or any court of the District of Columbia by doing any act or thing therein, or thereby forbidden to be done by him, if the act or thing so done by him be of such character as to constitute also a criminal offense under any statute of the United States or under the laws of any State in which the act was committed shall be proceeded against for his said contempt as provided in sections 387-390 of this title. (Oct. 15, 1914, c. 323, §21, 38 Stat. 738.)"

Title 28, Section 387, as it existed at the time of the alleged offenses is as follows:

§387. Same; procedure; bail; attachment; trial; punishment. Whenever it shall be made to appear to any district court or judge thereof, or to any judge therein sitting, by the return of a proper officer on lawful process, or upon the affidavit of some credible person, or by information filed by any district attorney, that there is reasonable ground to believe that any person* has been guilty of criminal contempt, the court or judge thereof, or any judge therein sit-

ting, may issue a rule requiring the said person so charged to show cause upon a day certain why he should not be punished therefor, which rule, together with a copy of the affidavit or information, shall be served upon the person charged, with sufficient promptness to enable him to prepare for and make return to the order at the time fixed therein. If upon or by such return, in the judgment of the court, the alleged contempt be not sufficiently purged, a trial shall be directed at a time and place fixed by the court. If the accused, being a natural person fail and refuse to make return to the rule to show cause, an attachment may issue against his person to compel an answer, and in case of his continued failure or refusal, or if for any reason it be impracticable to dispose of the matter on the return day, he may be required to give reasonable bail for his attendance at the trial and his submission to the final judgment of the court. Where the accused is a body corporate, an attachment for the sequestration of its property may be issued upon like refusal or failure to answer.

“In all cases within the purview of sections 381 to 383, 386 to 390 of this title, section 412 of Title 18, section 52 of Title 29 and sections 12, 13 and 14-27 of Title 15, such trial may be by the court, or, upon demand of the accused, by a jury; in which latter event the court may impanel a jury for the jurors then in attendance, or the court or the judge thereof in chambers may cause a sufficient number of jurors to be selected and summoned, as provided by law, to attend at the time and place of trial, at which time a jury shall be selected and impaneled as upon a trial for misdemeanor; and such trial shall conform, as near as may be, to the practice in criminal cases prosecuted by indictment or upon information.

“If the accused be found guilty, judgment shall be entered accordingly, prescribing the punishment, either by fine or imprisonment, or both, in the discretion of the court. Such fine shall be paid to the United States or to the complainant or other party injured by the act constituting the contempt, or may, where more than one is so damaged, be divided or apportioned among them as the court may direct, but in no case shall the fine to be paid to the United States exceed, in case the accused is a natural person, the sum of \$1,000, nor shall such imprisonment exceed the term of six months. In any case the court or a judge thereof may, for good cause shown, by affidavit or proof taken in open court or before such judge and filed with the papers in the case, dispense with the rule to show cause, and may issue an attachment for the arrest of the person charged with contempt; in which event such person, when arrested, shall be brought before such court or a judge thereof without unnecessary delay and shall be permitted to bail in a reasonable penalty for his appearance to answer to the charge or for trial for the contempt; and thereafter the proceedings shall be the same as provided herein in case the rule had issued in the first instance. (Oct. 15, 1914, c. 323, §22, 38 Stat. 738.)”

It will be seen, therefore, that neither the information charges nor does the evidence show any *willful* disregard of the injunction.

In speaking of the word “willful” in *Screws v. United States*, 325 U. S. 91-161, the court pointed out:

“And we are told ‘wilfully’ was added to §20 in order to make the section ‘less severe.’ 43 Cong. Rec., 60th Cong., 2d Sess. p. 3599.

“We hesitate to say that when Congress sought to enforce the Fourteenth Amendment in this fashion it did a vain thing. . . .

“We recently pointed out that ‘willful’ is a word ‘of many meanings, its construction often being influenced by its context.’ . . . But ‘when used in a criminal statute it generally means an act done with a bad purpose.’ *Id.*, 290 U. S. 394, 78 L. ed. 384, 54 S. Ct. 223. And see *Felton v. United States*, 96 U. S. 699, 24 L. ed. 875; *Potter v. United States*, 155 U. S. 438, 39 L. ed. 214, 15 S. Ct. 144; *Spurr v. United States*, 174 U. S. 728, 43 L. ed. 1150, 19 S. Ct. 812; *Hargrove v. United States* (C. C. A. 5th), 67 F. (2d) 820, 90 A. L. R. 1276. In that event something more is required than the doing of the act proscribed by the statute. Cf. *United States v. Balint*, 258 U. S. 250, 66 L. ed. 604, 42 S. Ct. 301. An evil motive to accomplish that which the statute condemns becomes a constituent element of the crime. *Spurr v. United States*, *supra* (174 U. S. 734, 43 L. ed. 1152, 19 S. Ct. 812); *United States v. Murdock*, *supra* (290 U. S. 395, 78 L. ed. 385, 54 S. Ct. 223). And that issue must be submitted to the jury under appropriate instructions. *United States v. Ragen*, 314 U. S. 513, 524, 86 L. ed. 383, 390, 62 S. Ct. 374.”

Under the explanation of the word “willful” as defined in *Screws v. United States*, we must take it to apply to Sections 386 and 387, Title 28, which require not merely the doing of the act but the doing of the act “wilfully.”

See *Stein v. U. S.*, 153 F. 2d 737, 743. We are confronted then in this case with the fact the Government neither alleged nor did it prove any disobedience nor any *willful* disobedience of the court's order. If the provisions of the court be deemed to be strictly within the requirements of the statute, it is that the product must contain a label with *adequate directions for its use*. There is nothing shown in the entire record that the labels were not *adequate* for its use.

The record clearly shows, without dispute, not only that the appellant did not act wilfully, as that term has been defined, but that they made a *determined and good faith effort* to comply with the court's injunction. Also, it appears without dispute that the labels contained adequate direction for uses of the product.

An information which fails to show "willful" violation where the statute requires willfulness fails to charge a public offense. Likewise, it would fail to charge contempt whereas here section 386 requires it.

It will be noted that in the case of *United States v. United Mine Workers of America*, 330 U. S. 298, 91 L. Ed. 915, there is a footnote to the case which says:

"Noteworthy also is the allegation in the affidavit that the defendants' violation of the restraining order 'had interfered with this Court's jurisdiction.' And the charge in the petition of '*willfully . . . and deliberately*,' disobeying the restraining order indicates an intention to prosecute criminal contempt."

II.

The Record Clearly Shows, Without Dispute, That Appellants Made a Determined and Good Faith Effort to Comply With Injunction.

The record shows, without contradiction, that immediately after the issuance of the injunction involved in this case, appellants went to considerable trouble and expense in their efforts to rearrange their labeling so as to comply with the court's decree. The undisputed testimony of Mr. Colgrove reflects this phase:

"But certainly I acted in the best of faith as far as trying to conform that advertising with the injunction decree and in every act in the conduct of the business, even to the extent of suspending all intrastate shipments as well as interstate shipments following the decree until new labels were printed to conform with the decree, ordering back merchandise that could have been sold in the states from which it was returned without violation of the injunction, but at a cost of several hundred dollars. In order to comply, in good faith, I wanted it returned and relabeled; and that is about all there is to it.

Q. There was no intent on your part at any time to violate this injunction? A. Positively not.

Q. You did everything you felt that was in your power towards conforming with it? A. I did." [R. 63.]

The essence of contempt is, of course, *the willful or deliberate violation of the court's decree.*

"To constitute criminal contempt acts of disobedience must be characterized by deliberate intention to

defy the authority of the court. The act must be done wilfully and with the intention to show disrespect for the defiance of the court. Intent is an essential element of the criminal contempt." (Dangel on Contempt, p. 75.)

In *United States of America v. United Mine Workers of America*, 330 U. S. 258, 91 L. Ed. 884, the court in pointing out the procedural steps taken in that case, the court there found the defendants "guilty beyond a reasonable doubt." (330 U. S. 269, 91 L. Ed. 900.)

The court also found a "wilful and intentional" flaunting of the court's order and no attempt whatsoever to make any compliance with it.

III.

No Flaunting of Court's Order or Any Willfulness Proved.

Certainly, under the facts clearly shown in this case, it cannot properly be said that there was any proof of any such a flaunting or disregard for the court's decree. To the contrary, the record plainly reveals absence of wilfulness and a good faith effort to comply with it.

And, in this connection, it should be remembered that the lower court, in requiring appellants to change their labels, did not map out or specify the manner in which this should be done, or lay down any definite standards or criteria to guide the appellants in doing this. The injunction decree was quite general. In short, appellants had to use their own judgment in determining how just to meet the requirements of this indefinite decree. The record shows that they did make a conscientious effort to do so.

Furthermore, any suggestion or intimation that appellants deliberately schemed to evade and defy the court's decree, becomes, we respectfully submit, patently fatuous when it is realized that there was absolutely no motive or reason for any such conduct. Why would appellants do such a thing and risk the penalties of a criminal contempt when they had nothing whatsoever to gain by such conduct. All they had to do (according to the government's theory of this case), in order to comply with the injunction, was simply to add the names of the alleged "omitted" diseases (poison oak, etc.) to the label. It is conceded by the government that the "directions for use" on the label, psoriasis, eczema, athlete's foot and leg ulcers, *are entirely adequate insofar as the diseases named on the label are concerned.* What the government complains of is that appellants named diseases in their advertising material which were not named on the label. Certainly, it would seem to be the height of folly, to put it mildly, for appellants to risk the severe penalties of contempt when the whole matter could have been readily resolved by a few printed words on the label of the names of skin ailments.

It is contended that if the names were added that the directions already on the label of the bottle were not inadequate. It is merely contending that these additional ailments in the testimonial in the newspaper advertising were not on the label. Congress did not require that the label contain the names of the ailments particularly. All that it requires is that *adequate* directions be required for their uses.

IV.

The Question Here Is Whether Newspaper Advertising in Testimonials Constitute “Labels” or Come Within Its Orbit?

This case does not merely involve the single issue of whether the defendant was guilty of violating a court order and therefore in contempt but involves a question of newspaper advertising, of the character here involved, as it affects the Pure Food and Drug Statute.

If the statute is to be construed as intended by the appellee, then every label in any cosmetic case would have to contain every kind of directions for every powder puff that was advertised in any newspaper and a letter appraising some kind of powder puff, and a testimonial published in a newspaper would require the seller of that product to put a label on that bottle telling the woman just how to use the puff to powder her face, and if somebody inadvertently said she used the puff for shiny skin the bottle, under the authority of the appellee, would have to designate “shiny skin” because someone had written a testimonial in a newspaper about its use for that purpose.

We do not believe that Congress intended, nor does the Statute say, that the label must contain the name of every use for which the product is intended. All that the statute intends is that the label contain adequate directions for its use, even though the label does not specify any uses.

Here, the label specified the distinct use with directions thereon for its use and it was conceded by the Government during the oral argument that the label contained adequate directions for every use specified on the bottle

itself, and that the label was adequate for those uses, to wit, Eczema, Psoriasis, Athlete's Foot and Leg Ulcers. No question is raised by the Government in the oral argument as to the good faith of the appellant in respect to these four items. It is conceded that he showed every good faith. But by innuendo indirections and matters not referred to in the record of the case itself, the Government counsel (not the attorney who argued) had attempted to inject matters outside the record. We think this is unfortunate and unfair, but, this court consisting of learned judges, we know that such tactics as usually resorted to before a jury will not be considered by this court.

It would have been a simple matter for the appellant, who spent thousands of dollars recalling his product, to relabel it to add the other names set out in the newspaper testimonials as to the efficacy of the product. No challenge is here made as to the truthfulness of those advertisements for it cannot be. They have appeared in newspapers for years and withstood the acid test of the Federal Trades Commission and the Post Office Department. If they were false, the statutes of those two departments would have covered the matter. The presumption is that they have performed their duties and that the product has done all that the advertisement said.

Therefore, the only questions left are whether testimonials printed in a newspaper regarding the product are "prescribing, recommending and suggesting its uses where the label specifies its uses for four products and where the label gives adequate directions for its uses regardless of whether the label itself specifies the uses named in the testimonials, and further whether those uses are in any event merely specific applications of the generic term for which the use is designed.

V.

**Newspaper Advertising Is Not “Labeling.” The
Solicitor General so Stated Before the United
States Supreme Court in Another Case.**

The statute under the authority of which the injunction was issued provides as follows:

“Section 301(a) of the Act, 21 USCA, §331(a), 5 FCA, Title 21, §331(a), prohibits the introduction into interstate commerce of any drug that is adulterated or misbranded. It is misbranded according to §502(a), 21 USCA, §352(a), 5 FCA, Title 21, §352(a) if its ‘labeling is false or misleading in any particular,’ unless the labeling bears ‘adequate directions for use.’ §502(f). The term labeling is defined in §201(m), 21 USCA, §321(m), 5 FCA, Title 21, §321(m), to mean ‘all labels and other written, printed, or graphic matter (1) upon any article or any of its containers or wrappers, or (2) accompanying such article.’”

The first question here involved is whether testimonials contained in a newspaper advertisement published in newspapers of the city where the article is to be sold, comes within the definition of a “label” within the meaning of the Act. And, therefore, whether the Court has any jurisdiction, either of the whole newspaper ad or that portion which relates merely to testimonials.

The subject of “labeling” was fully discussed before the United States Supreme Court in the case of *Kordel v. United States*, decided by the Supreme Court November 22, 1948, 93 L. Ed. (Adv.) 74, in which the Court held that “literature that was used in the sale of the drugs, which explained their uses and where the purchaser was

advised not to use them, and constitute an *essential* supplement to the label attached to the package was labeling within the meaning of the Act." And, in arguing that case before the Supreme Court of the United States attention was called to the Supreme Court that this *advertising* as such was eliminated from the bill in the historic consideration of it before its passage.*

The Government has confused newspaper advertising with labeling, but newspaper advertising is not within the sphere or scope of the act, nor is it within the congressional intent. The earlier drafts of the pure food and drug act introduced into Congress contained the following definition distinguishing the two concepts. Thus, S. 2800 contained the following definitions distinguishing the two concepts:

"Section 2. As used in this act, unless the context otherwise indicates—

* * * * *

(i) The term 'labeling' includes all labels and other written, printed, and graphic matter, in any form whatsoever, accompany any food, drug, or cosmetic.

(j) The term 'advertisement' includes all representations of fact or opinion disseminated in any manner or by any means other than by the labeling."

*At the time the Supreme Court of the United States decided *Kordel v. United States*, 93 L. Ed. 74, it also decided *United States v. Urbuteit*, 93 L. Ed. 79. This case involved statements that were false and misleading. The Government stated, in oral argument they did not believe this case particularly in point. We agree but we cite it for the court's information as we did in the oral argument.

(Reprinted in full in Hearings Before the Committee on Commerce, United States Senate, 73d Cong., 2d Sess., pp. 1-12.)

This definition was not included in the statute as finally passed. The final bill, as amended, omitted the advertising provision. Congressional intent is evident from the debate in the House of the first S. 5 (80 Cong. Rec. 10230-10244, 1936) and on the final measure (83 Cong. Rec. 391-424, 1938) and in the Senate on the conference report (83 Cong. Rec. 3287-3293, 1938).

VI.

Newspaper Advertising Only Under Control of Federal Trade Commission.

Thus the control of advertising has been left clearly to the Federal Trade Commission and although there have been repeated efforts in Congress by the Food and Drug Administration to include newspaper advertising, as such, within its orbit. That effort has been rejected by Congress. Such decisions of Congressional action are important.

Section 12 of the Federal Trades Commission Act, Public Law 203, 63d Congress, as amended by 7th Congress, 52 Stat. 114; U. S. C. 15:42, provides as follows:

“Sec. 12. False Advertisement of Foods, Drugs,, Devices or Cosmetics as Unfair or Deceptive Act of Practice and Unlawful. (52 Stat. 114; U. S. C. 15:42).

Sec. 12. (a) It shall be unlawful for any person, partnership, or corporation to disseminate, or cause to be disseminated, any false advertisement—

(1) By United States mails, or in commerce by any means, for the purpose of inducing, or which is likely to induce, directly or indirectly the purchase of food, drugs, devices, or cosmetics; or

(2) By any means, for the purpose of inducing, or which is likely to induce, directly or indirectly, the purchase in commerce of food, drugs, devices, or cosmetics.

(b) The dissemination of the causing to be disseminated of any false advertisement within the provisions of subsection (a) of this section shall be an unfair or deceptive act or practice in commerce within the meaning of section 5."

Section 15 of the Act provides in part as follows:

"Sec. 15. 'False Advertisement,' 'Food,' 'Drugs,' 'Devices,' 'Cosmetics,' Defined. (52 Stat. 116; U. S. C. 15:55.)

Sec. 15. For the purposes of sections 12, 13 and 14—

(a) The term 'false advertisement' means an advertisement, other than labeling, which is misleading in a material respect; and in determining whether any advertisement is misleading, there shall be taken into account (among other things) not only representations made or suggested by statement, word, design, device, sound, or any combination thereof, but also the extent to which the advertisement fails to reveal facts material in the light of such representations or material with respect to consequences which may result from the use of the commodity to which the advertisement relates under the conditions prescribed in said advertisement, or under such conditions as are customary or usual. No advertisement of a drug

shall be deemed to be false if it is disseminated only to members of the medical profession, contains no false representation of a material fact, and includes, or is accompanied in each instance by truthful disclosure of, the formula showing quantitatively each ingredient of such drug."

Congress, not having placed newspaper advertising within the jurisdiction of the Federal Trade Commission and not within the jurisdiction of the Pure Food and Drug Administration, it is clear that newspaper advertising was never intended to come within the jurisdiction or scope of the Commission or any orders pursuant to its request. And, since counsel for the Pure Food, Drug and Cosmetic Administration have gone outside the record of this case to attempt to malign the appellants, we deem it appropriate to reply that Colusa Mineral Oil has been on the market seven years, has been thoroughly checked by Federal Trade Commission. The Federal Trade Commission has not at any time ever instituted a complaint or cause of action against the appellants.

The law presumes that Federal Trade Commission has been doing its duty as fully as has the Pure Food, Drugs and Cosmetic Administration. We mention this because of the comment (though withdrawn) made by a learned member of the court but which might have been evoked by statements made by Government counsel in their brief which were outside of the record and not properly within the scope of this appeal.

The Government concedes, as it must, that the bottles were correctly labeled for the uses intended for the matters stated on the label, to-wit, eczema, psoriasis, athlete's foot and leg ulcers.

It therefore is apparent that the court was without jurisdiction to make the order with reference to newspaper advertising and that the order was wholly void.

This interpretation was placed upon the law by the Solicitor General himself in the argument on the *Kordel* case. In his argument Mr. Perlman, the Solicitor General, referred to the definition of advertising which was deleted from one of the earlier food and drug bills. Mr. Perlman then stated, "that the advertising which Congress had in mind when it transferred jurisdiction to the FTC was that found in newspapers, periodicals and radio commercials. This type of advertising, he contended, is entirely different from the labels, circulars and other printed matter used in connection with drugs or devices and designed to mislead and defraud the general public." (16 Law. Week. 3108.)

We agree with the Solicitor General's argument before the Supreme Court of the United States. Such argument removed the jurisdiction of the District Court to issue the injunction here.

Here the advertisements in question did not perform the function of labeling. The bottles had labels on them which contained adequate directions for the use of the preparation. [R. 22.] The bottle was labeled. All that the Act requires is "adequate directions for the use of the product." It does not require naming any or all of the uses of the product—all it requires is adequate directions for the use of the product.

Nowhere in the evidence is there any showing that the directions contained on the label were not "adequate in every way" for all of the possible uses of the products.

It is conceded by the Government that the label on the bottle was fully adequate in the treatment of Psoriasis, Eczema, Athlete's Feet and Leg Ulcers, for which the bottle was adequately labelled and designated, and the efficacy of the remedy and its proper uses are not challenged for these particular specifically named items. But, nowhere in the evidence has there been any showing that even if the items be expanded to include other types of skin suffering that the label was not adequate and therefore that the injunction had been in any way violated.

The injunction in requiring specific directions and the judgment in punishing the defendant for failing to bear "specific directions" also was beyond the scope of the statute. or the court's jurisdiction of the subject matter.

VII.

The Court Was Without Jurisdiction to Make the Order.

During the oral argument, we raised the point that the court was without jurisdiction to make the order regarding newspaper advertising and therefore there was no jurisdiction of the subject matter and therefore there could be no contempt. Citing *Re Sawyer*, 124 U. S. 200, 31 L. Ed. 402; *Ex parte Fisk*, 113 U. S. 713, 28 L. Ed. 1117; *Ex parte Rowland*, 104 U. S. 604, 26 L. Ed. 861; *Beauchamp v. United States*, 76 F. 2d 663.

The learned Chief Judge called our attention to the case of *United States v. United Mine Workers of America*. That case does not vitiate the doctrines herein set out, but in fact re-affirms them. (330 U. S. 291.) The *Mine Workers* case merely held that where an injunction is issued by a court having jurisdiction of both the person and

the subject matter that the party attempting wilfully to disobey such an order did so at their peril if their disobedience was based on a belief that the law is unconstitutional. That case involved the question of the validity and application of the Norris-LaGuardia Act and the War Labor Disputes Act.

In the *United Mine Workers*' case, the court said:

“In the case before us, the District Court had the power to preserve existing conditions while it was determining its own authority to grant injunctive relief. The defendants in making their prior determination of the law, *acted at their peril*.”

“Although a different result would follow were the question of jurisdiction frivolous and not substantial, such contention would be idle here.”

The court further said that there was a duty of obedience “where, as here, the *subject matter of the suit*, as well as the parties, was properly before the court; where the elements of federal jurisdiction were clearly shown; and where the authority of the court of first instance to issue an order ancillary to the main suit depended upon a statute, the scope and applicability of which were subject to substantial doubt.” This is not true, however, in the present case where the court never did have jurisdiction to issue an injunction under the Pure Food, Drugs and Cosmetics Act applicable to and affecting newspaper advertising and not within the scope of the suit and, therefore the subject matter was never within the jurisdiction of the District

Court. Under such circumstances, the order was void and could be disregarded as a void order.

Beauchamp v. United States, 76 F. 2d 663, 9th Cir. Ct.;

United States of America v. United Mine Workers' of America, 330 U. S. 258;

Ex parte Fisk, 113 U. S. 713, 28 L. Ed. 1117;

Ex parte Rowland, 104 U. S. 604, 26 L. Ed. 861;

Re Sawyer, 124 U. S. 300, 31 L. Ed. 402.

We do not, in urging this point, say that the appellants here at any time chose to disregard the court's order because they thought it void. On the contrary, they made every effort to obey the order, even though it was void by having been charged with contempt for failure to comply with the order. We submit that the court never did have jurisdiction to make the order and that, as construed by the court, in the last proceeding, such construction included a subject matter not within the jurisdiction of the trial court, or in the action herein had.

As to the power of the court to punish for contempt: In considering whether the punishment could be divisible and charged as several contempts, it must be born in mind this is not a case where one is charged with several violations of a statute but is charged with a violation of a court decree or injunction. It the *Mine Workers'* case the matter was judged as a single contempt although the strikers continued for 15 days to disobey the injunction of the court.

VIII.

There Has Not Been the Slightest Showing in This Case That the "Directions for Use" on the Labels in Question Were Not Adequate for the Treatment of the "Omitted" Diseases (Poison Oak, etc.).

The government's entire case is predicated upon a false premise, as stated above. The basic assumption underlying this entire proceeding is the government's claim that appellants were in violation of this injunction because they did not list *on the bottle label the names of these several "omitted" skin ailments (poison oak, etc.), i.e., the diseases mentioned in the testimonials but not on the label.* In other words, the government proceeds upon the theory that this injunction required that the names of all the diseases for which this drug is "prescribed, recommended and suggested" *be printed on the label.* The following statement of the government's counsel (printed at page 19 of our Opening Brief) well illustrates and epitomizes this basic concept of the government:

"The Court: Is it the Government's contention that this advertisement becomes in effect a part of the label.

Mr. Klinger: Not necessarily a part of the label, Your Honor, no; but it is in conflict with the court's order heretofore entered, which is, pursuant to the statute, that the defendants are not, *in their advertising*, after those injunctions, to recommend, suggest or prescribe this product *for any conditions, any of the disease conditions other than those named on the label.*" (Emphasis ours.) [R. 53.]

The following remark of the lower court sums up this basic idea of the government:

“The Court: The entire complaint here is that they were not included.” [R. 74.]

This basic premise of the government is, we respectfully submit, absolutely unsound, as we will try to quickly again demonstrate. The injunction did *not* require that *the label* contain the names of all the various ailments for which this drug is “prescribed, recommended and suggested” *in the advertising material*. All that the injunction requires is that *the label* contain *adequate (or specific directions)* for use of this drug in the treatment of the diseases for which the drug is “prescribed,” 35c.) *in the advertising materials of the defendants*.

Now, it would seem almost elementary, we respectfully submit with all due deference, that in order to prove a violation of this injunction the most vital and indispensable part of the government’s case and proof would be to prove that the “directions for use” admittedly on this label were *not adequate* in the treatment of these “omitted” diseases (poison oak, etc.). In other words, it is *the absence of adequate directions* which is the very essence of the alleged violation. No proof whatsoever, was made that the directions in question were *not adequate* for these diseases.

Stating the matter a little differently, it would not even be necessary, under this decree, that any of the diseases for which this drug is “prescribed,” etc., be actually named *on the label*. This naming and “prescribing” for example, could be done in the advertising material and if, in fact, the directions for use on the label are adequate, there could and would be no violation of this decree.

Repeating, in our case, there was not the slightest proof that the directions for use were or are *not adequate* for these “omitted” diseases.

The simple and indisputable *truth is that these directions were and are entirely adequate.* *The oil is used and applied, in the treatment of these several ailments (poison oak, etc.) in exactly the same way as in the treatment of the several diseases named on the label, as to which diseases the government concedes the directions for use are entirely adequate.*

The burden was, of course, upon the government to prove every essential element of this serious criminal charge by competent evidence and beyond a reasonable doubt. This necessarily means that the burden was upon the government to show, by proper evidence, that the directions for use were *not* adequate in the treatment of the "omitted" diseases. The govenrment failed completely to prove any such a thing.

1. The record plainly shows a good faith effort by appellants to comply with this decree even though void for want of jurisdiction of the subject matter of advertising. Hence there was no contempt.
2. Appellants did not violate this injunction because:
 - A. They did not "prescribe, recommend and suggest" this drug for the "omitted" diseases.
 - B. These diseases are mere forms of skin suffering and come within the definitions of the generic terms on the label. The government failed to prove otherwise. In any event the "directions for use" were and are adequate for treatment of these "omitted" diseases.
3. The government wholly failed to show that the "directions for use" on these labels were not adequate in the treatment of these omitted skin diseases.

Conclusion.

1. The order of the court was not violated. The order was in the conjunctive and the judgment, contrary to the order, was in the disjunctive.
2. The information did not charge wilful violation as required by the statute regarding contempt.
3. There was no proof of willfulness. There was no proof of any violation beyond a reasonable doubt.
4. The statute only requires adequate directions for use. There was no showing that the directions for uses were not adequate.
5. Newspaper advertising is not within the scope and jurisdiction. The court therefore acted beyond his jurisdiction of the subject matter and its order was therefore in fact void.
6. Contempt for an order of the court has not been made divisible by the Act of Congress.

For which lack of jurisdiction and error, we respectfully pray for reversal of the judgments.

Respectfully submitted,

MORRIS LAVINE,

Attorney for Appellants.

No. 11832

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CHESTER WALKER COLGROVE, Trading and Doing Business Under the Firm Name of Colusa Remedy Company, and COLUSA REMEDY COMPANY, a Corporation.

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S SUPPLEMENTAL BRIEF.

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TOPICAL INDEX

| | PAGE |
|--|------|
| I. | |
| Newspaper advertising is not labeling..... | 1 |
| II. | |
| Willfulness is not a statutory element of the offense charged..... | 2 |
| III. | |
| The meaning of "prescribed, recommended, and suggested"..... | 8 |
| IV. | |
| Regulation of cosmetics..... | 10 |
| V. | |
| Form of judgment..... | 10 |
| Conclusion | 11 |

TABLE OF AUTHORITIES CITED

| CASES | PAGE |
|--|------|
| Barnes et al. v. United States, 142 F. 2d 648..... | 7 |
| Braun, In re, 259 Fed. 309..... | 4 |
| Eustace et al. v. Lynch, 80 F. 2d 652..... | 4 |
| Forrest v. United States, 277 Fed. 873; cert. den. 258 U. S. 629 | 3 |
| Hill v. United States ex rel. Weiner, 300 U. S. 105..... | 3 |
| Screws v. United States, 325 U. S. 91..... | 5, 6 |
| Sylvester, et al., In re, 41 F. 2d 231..... | 5 |
| Triangle Candy Co. v. United States, 144 F. 2d 195..... | 7 |
| United States v. Dotterweich, 320 U. S. 277..... | 6 |
| United States v. Ford, 9 F. 2d 990..... | 5 |
| United States v. Greenbaum, 138 F. 2d 437..... | 7 |
| United States v. Johnson, 52 Fed. Supp. 382..... | 5 |
| United States v. Sanders, 290 Fed. 428..... | 5 |
| United States v. Sullivan, 68 S. Ct. 331..... | 10 |
| Walden v. Hudspeth, 115 F. 2d 558..... | 11 |
| Wilson v. Bell, 137 F. 2d 716..... | 11 |

CYCLOPEDIA

| | |
|---|---|
| Cyclopedia of Federal Procedure (2d Ed.), Secs. 7222, 7232..... | 3 |
|---|---|

STATUTES

| | |
|---|------|
| Clayton Act (28 U. S. C., Sec. 386)..... | 2, 3 |
| Clayton Act (28 U. S. C., Sec. 387)..... | 2, 3 |
| Clayton Act (28 U. S. C., Sec. 389)..... | 2, 3 |
| Federal Food, Drug and Cosmetic Act (21 U. S. C., Sec. 331 (a)) | 7 |
| Federal Food, Drug and Cosmetic Act (21 U. S. C., Secs. 332(a), 337) | 3 |
| Judicial Code, Sec. 268 (28 U. S. C., Sec. 385)..... | 3, 6 |
| United States Code, New Title 18, Sec. 401..... | 3 |
| United States Code, New Title 18, Sec. 402..... | 3 |
| United States Code, Title 21, Secs. 321(i), 361, 362, 363, 364..... | 10 |
| United States Code, Title 21, Sec. 332(b)..... | 7 |
| United States Code, Title 21, Sec. 352(f)..... | 10 |

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vs.

UNITED STATES OF AMERICA,

Appellee.

APPELLEE'S SUPPLEMENTAL BRIEF.

Appellants have filed a supplemental brief, most of which is devoted to further argument and reiteration of points already covered in the main briefs.

I.

Newspaper Advertising Is Not Labeling.

Appellants contend most emphatically that newspaper advertising is not "labeling" within the meaning of the Federal Food, Drug, and Cosmetic Act. (Appellants' Supp. Br. 17-23.) The Government has made no contention to the contrary. Rather, we have consistently pointed out that the injunctions upon which the present contempt

action was based in no way regulated, or attempted to regulate, appellants' newspaper advertising. (Appellee's Br. 23.) The injunctions were directed entirely at the labeling of the product—a subject plainly within the jurisdiction of the Court below. (Appellee's Br. 17-18.)

II.

Willfulness Is Not a Statutory Element of the Offense Charged.

Appellants now seek to inject one new point into this proceeding, a point not heretofore raised in the District Court or in this Court. They assert that the statute authorizing this contempt action requires a *willful* disregard of the Court's injunctions. (Appellants' Supp. Br. 6-14.) Since the instant Information does not charge that the acts of disobedience were willful, Appellants conclude that the Government failed to charge an offense.

Where a statute specifies that willfulness is an element of an offense, then, of course, an information based upon that statute should ordinarily charge that the act complained of was done willfully.

The fallacy in Appellants' argument is that it relies upon the wrong statute. Appellants, in their latest brief (pages 7-8), set forth two sections of the Clayton Act which seemingly support their position. [28 U. S. C. 386, 387.] However, Appellants fail to call attention to a third section of the Clayton Act, 28 U. S. C. 389, which reads in pertinent part:

“Nothing contained in sections 386 to 388 and 390 of this title shall be construed to relate to contempts committed in . . . disobedience of any unlawful writ, process, order, rule, decree, or command entered

in any suit or action brought or prosecuted in the name of, or on behalf of, the United States, but the same, and all other cases of contempt not specifically embraced within section 386 of this title, may be punished in conformity to the usages at law and in equity prevailing on October 15, 1914.” (Emphasis added.)

Since the injunction suits in the instant case were brought *in the name of and on behalf of the United States* pursuant to the authority of the Federal Food, Drug, and Cosmetic Act [21 U. S. C. 332(a) and 337], it is clear that the requirement of willfulness as set forth in the Clayton Act [28 U. S. C. 386] is not applicable here. See *Forrest v. United States*, 277 Fed. 873, 876 (C. C. A. 9, 1922), cert. denied 258 U. S. 629; *Hill v. United States ex rel. Weiner*, 300 U. S. 105, 108 (1937). In our opening brief, page 34, footnote 3, we have already indicated the limited extent to which one section of the Clayton Act [28 U. S. C. 387] is applicable.

In the absence of a specific governing statute, the federal courts have general authority to punish contempts under Section 268 of the Judicial Code, 28 U. S. C. 385.¹ [See Cyclopedia of Federal Procedure, 2nd Editions, Sections 7222 and 7232.] This provision declares:

“The courts of the United States shall have power to impose and administer all necessary oaths, and to punish, by fine or imprisonment, at the discretion of the court, contempts of their authority. Such power

¹This provision now appears in substantially the same language in the new Title 18, United States Code, Section 401. It will be noted that Section 402 of new Title 18 is the equivalent of former 28 U. S. C. 386-389. Willfulness remains an element of Section 402 but is still not an element of Section 401.

to punish contempts shall not be construed to extend to any cases except the misbehavior of any person in their presence, or so near thereto as to obstruct the administration of justice, the misbehavior of any of the officers of said courts in their official transactions, *and the disobedience or resistance by any such officer, or by any party, juror, witness, or other person to any lawful writ, process, order, rule, decree, or command of the said courts.*" (Emphasis added.)

Manifestly, the word "willful" does not precede the word "disobedience" in this provision. For this reason alone, we submit that an Information based on this statute is not defective if it does not charge that the contemptuous acts were done "willfully."

Moreover, there are a number of cases which rest upon the proposition that disobedience of a court order without more is a punishable act of contempt, and that the good faith or intent of the defendant may serve only in mitigation of the penalty, not as a defense.

Thus, in *Eustace et al. v. Lynch*, 80 F. 2d 652 (C. C. A. 9, 1935), this Court said at page 656:

"While the advice of an attorney is not a defense to an act of contempt, it is a matter to be considered in mitigation in a trial for criminal contempt."

In the case of *In re Braun*, 259 Fed. 309 (M. D. Pa., 1919), the Court stated at page 311:

"Though there was disobedience to the command and order of the court, the evidence satisfies the court that there was no actual moral intent to defy the court

or its order, and, while this is no defense, it serves to mitigate the punishment."

In *United States v. Sanders*, 290 Fed. 428 (W. D. Tenn., 1923), it was demonstrated to the satisfaction of the Court that defendant's publication tended to obstruct justice. The Court then considered defendant's argument that he had not intended to speak disrespectfully of the Court, saying on page 437:

"If there was no intention to reflect upon the court this can only be considered in mitigation of the offense."

To the same effect, see also:

United States v. Ford, 9 F. 2d 990, 992 (D. Mont., 1925);

In re Sylvester, et al., 41 F. 2d 231, 236 (S. D. N. Y., 1930);

United States v. Johnson, 52 Fed. Supp. 382, 384 (W. D. N. Y., 1943).

Appellants quote at some length from *Screws v. United States*, 325 U. S. 91, 100-101. The statute there involved had been specially amended by Congress in order to add the word "willfully." Justice Douglas points out (pages 106-7) that not only did the indictment not charge that the offense had been committed willfully, *but also the charge to the jury failed to instruct the jury that before returning a verdict of guilty they must find defendants to have acted willfully.*

In contrast to the situation which prevailed in the *Screws* case, the statute upon which the present case is

based does not specify willfulness as an element of the offense, yet at the trial both the Court and the attorneys assumed that a criminal intent had to be established. [R. 74-77.] Consequently, as a practical matter, Appellants received the full benefit which might have been derived from the inclusion of the word "willful" in each Count of the Information. Hence, the defect, if any, in the Information was harmless.

Furthermore, the *Screws* case itself suggests the correctness of the construction which we urge for 28 U. S. C. 385, in accordance with its plain terms. At page 103 the Supreme Court said:

"Moreover, the history of §20 affords some support for that narrower construction. As we have seen, the word 'willfully' was not added to the Act until 1909. Prior to that time it may be that Congress intended that he who deprived a person of any right protected by the Constitution should be liable without more. *That was the pattern of criminal legislation which has been sustained without any charge or proof of scienter. Shevlin-Carpenter Co. v. Minnesota*, 218 U. S. 57; *United States v. Balint, supra.*" (Emphasis added.)

The Supreme Court has upheld the validity of criminal statutes which do not prescribe "criminal intent" or "willfulness" as an element, and has given effect to the Congressional conclusion not to make intent or willfulness a necessary element.

Thus in *United States v. Dotterweich*, 320 U. S. 277, the Court declared (page 281) that the Federal Food, Drug, and Cosmetic Act dispenses with the conventional

requirement for criminal conduct—awareness of some wrongdoing.” Accord:

Triangle Candy Co. v. United States, 144 F. 2d 195, 199 (C. C. A. 9, 1944);

Barnes et al. v. United States, 142 F. 2d 648, 651 (C. C. A. 9, 1944);

United States v. Greenbaum, 138 F. 2d 437 (C. C. A. 3, 1943).

It will be noted that the contemptuous acts here involved were also violations of the Federal Food, Drug, and Cosmetic Act [21 U. S. C. 331(a)] for which criminal prosecution could have been brought under 21 U. S. C. 333(a) without charging “a criminal intent.” [See 21 U. S. C. 332(b).] Since the Court’s power to punish for contempt was here invoked, and since the statute upon which that power is based does not specify “criminal intent” or “willfulness” as an element, we submit it was entirely proper not to inject the element of willfulness into the instant Information.

It is submitted that the Court should give full weight to the statute’s [28 U. S. C. 385] declared purposes of preventing obstruction of the administration of justice and disobedience of the orders of a Court. When a Court issues an order, that order should be obeyed. If it is not obeyed, there is a contempt. Unless the Court can exact obedience, its authority and dignity are impaired. Extinguishing circumstances such as good faith or ignorance, if present in a particular case, may properly be considered by the Court, not for the purpose of determining whether the defendant disobeyed the order, but rather for the purpose of perhaps mitigating the penalty.

III.

The Meaning of “Prescribed, Recommended, and Suggested.”

Appellants’ Supplemental Brief is interspersed with arguments repeating those already made both in their opening brief and orally, regarding the meaning of the words “prescribed, recommended, and suggested” as they appear in the injunctions. In addition to all that we have said in our original brief (Appellee’s Br. 24-30) and in oral argument establishing defendants’ violation of this command, we submit that these words should at least be given the primary meaning which the defendants understood them to have.

Defendant Colgrove felt that if he “advertised” his oil for certain ailments, then he “prescribed, recommended, and suggested” the oil for those ailments. Thus he testified [R. 62]:

“I did not ‘prescribe’ on the label for any of the fine-print diseases in the advertisement. *I had no intention of advertising any of the diseases in the advertisement except those that were highlighted in big type;* and that arrow pointing to those pictures was the intention of the arrow, and not pointing to the entire balance of the advertisement.” (Emphasis added.)

Defendant Colgrove further testified [R. 64]:

“Q. Mr. Colgrove, after the injunction the only change you made in the advertising was to delete the word ‘Acne,’ is that right? A. In that advertisement; yes, sir.

Q. And you felt after that proceeding before this court that by deleting the word 'Acne' from your advertising you were complying, in good faith, with the injunction of this court? A. I did; *because I felt that before deleting the word I was advertising for the five diseases named in the heading advertisement in the large type, and that as long as 'Acne' was not in the new label, I was obliged to delete it and did so.*

Q. But it is a fact, although deleting 'Acne' from the large print, it does appear in the testimonial part of the advertisement, is that right? A. *That is true, but it is not as advertised. Those things are psychologically cumulative and supportive. They were not definitely advertised.*" (Emphasis added.)

From the foregoing testimony it is clear that defendant Colgrove understood the injunctions to require that the labeling of Colusa Natural Oil come into the open and state all of the disease conditions for which the oil was "advertised." Nevertheless, the labeling stated only the four disease conditions that were highlighted in the advertising, and did not state the eight other disease conditions that appeared in the smaller print of the advertisement. In attempting to justify his action which was inconsistent with his own understanding of the requirements of the injunction, he offers the tenuous reasoning that two-thirds of the advertisement (the small print) is not "advertising," but merely "psychologically cumulative and supportive." We submit that this exercise in semantics ought not persuade this Court any more than it did the District Court.

IV.

Regulation of Cosmetics.

On page 15 of Appellants' Supplemental Brief, counsel seeks to impress this Court with a description of the dire consequences which would allegedly flow from an affirmance in this appeal: the label of every cosmetic case would have to bear adequate directions for using its powder puff to overcome "shiny skin." Counsel overlooks the fact that the Federal Food, Drug, and Cosmetic Act was carefully drafted. *United States v. Sullivan*, 68 S. Ct. 331, 337. Separate provisions of the Act define and deal with cosmetics, and prescribe special conditions under which cosmetics are adulterated or misbranded. [21 U. S. C. 321(i), 361, 362, 363, 364.] Even a casual perusal of these provisions will show that there is no requirement that the labeling of a *cosmetic* bear adequate directions for use, while of course, the *drug* provisions do so require. [21 U. S. C. 352(f).] It is hardly necessary to labor the reasons why Congress distinguished in this, and other ways, between a drug and a cosmetic.

V.

Form of Judgment.

Appellants complain that the judgments as filed used the word "or" rather than "and" in describing the offenses. [R. 34, 36.] They assert that this alone should reverse the judgments. (Appellants' Supp. Br. 3.) But the record is plain that at the close of the trial the Court found the defendants guilty "as charged" [R. 78, 79] in Counts

1-8 of the Information. And it is well settled that the judgment in a criminal case is the pronouncement by the judge from the bench, not the entry of the judgment by the Clerk.

Wilson v. Bell, 137 F. 2d 716, 720 (C. C. A. 6, 1943);

Walden v. Hudspeth, 115 F. 2d 558, 559 (C. C. A. 10, 1940).

Conclusion.

Such other matters as are adverted to in Appellants' Supplemental Brief have already been dealt with in our original brief and in our oral argument. We respectfully submit that the judgments of the District Court should be affirmed.

Respectfully submitted,

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Subject Index

| | Page |
|---|------|
| Introduction | 3 |
| The facts as to this controversy | 4 |
| I. The court in its opinion erred in inferentially holding that the evidence was sufficient to justify the finding and judgment of the court below holding the defend- ants guilty of criminal contempt | 5 |
| (1) The controlling law | 5 |
| (2) The proof required herein | 6 |
| (3) Was such proof adduced below? | 11 |
| II. There was no sufficient pleading of any criminal con- tempt; the court failed in its opinion to pass on this vital issue | 16 |
| Application of these settled principles to the informa- tion filed in this proceeding | 18 |
| III. The injunctive order was so vague and indefinite as not to be the basis of a contempt order and therefore vio- lated the Fifth and Sixth Amendments to the U. S. Constitution | 19 |
| IV. The Circuit Court erred in considering matters not before the trial court or properly before this court | 20 |
| V. The court failed to rule on the question of whether under the circumstances of this case there could be but a single contempt | 21 |
| VI. The court below was without jurisdiction to find appell- ants guilty of criminal contempt since newspaper ad- vertising, which formed the basis of the alleged con- tempt, is exclusively in the jurisdiction of the Federal Trade Commission and not the Pure Food and Drug Act under which this injunctive order was issued. This court should expressly pass upon this subject | 23 |
| VII. The court erred in not discussing or passing upon in its decision all other important points raised on our original appeal and which we reurge here by reference | 24 |
| Conclusion | 25 |

Table of Authorities Cited

| Cases | Pages |
|---|--------|
| Agnes v. United States, 165 U. S. 36 | 6 |
| Alberte v. United States, 159 F. (2d) 278 | 6 |
| Clary v. Commonwealth, 163 Ky. 48, 173 S. W. 171 | 17 |
| Collins v. U. S., 253 Fed. 609 (C.C.A. 9) | 17 |
| Estate of Ricks, 160 Cal. 467 | 20, 21 |
| Harris v. U. S. (C.C.A. Mo.), 104 F. (2d) 41 | 17 |
| Holt v. United States, 218 U. S. 245 | 6 |
| Jarl v. U. S. (C.C.A. Neb. 1927), 19 F. (2d) 891 | 17 |
| Kordel v. U. S., 93 L. Ed. 73 | 23, 24 |
| Kraus & Bro. v. U. S., 327 U. S. 614 (1946)..... | 19 |
| Marbury v. Madison, 1 Cranch (U.S.) 137, 2 L. Ed. 60 | 21 |
| McComb v. Jacksonville Paper Co., February 14, 1949, 93 Law. Ed. Advance Opinions, 457 | 5, 6 |
| Merwin v. People, 26 Mich. 298, 12 Am. Rep. 314 | 17 |
| Penfield v. Securities and Exchange Commission, 330 U. S. 585 | 6 |
| People v. Stephens, 79 Cal. 428 | 22 |
| Raskin v. Superior Court, 138 Cal. App. 668, 33 P. (2d) 35 | 6 |
| Tatum v. Levi, 3 Pac. (2d) 963 | 20, 21 |
| U. S. v. Aberback, 165 F. (2d) 713 | 16 |
| U. S. v. Balaban, 26 Fed. Sup. 491 | 6 |
| U. S. v. Hess, 124 U. S. 483, 8 S. Ct. 571, 31 L. Ed. 516 | 16, 17 |
| U. S. v. Morse, 287 Fed. 906 | 17 |
| U. S. v. Urbuteit, 93 L. Ed. 79 | 23, 24 |
| United States v. 9 Bottles of Colusa Natural Oil, 78 Fed. Supp. 721 | 20 |
| United States v. Resnick, 299 U. S. 207 | 6 |
| United States v. United Mine Workers, 330 U. S. 258 | 6, 16 |
| White v. U. S. (C.C.A. Okl. 1933), 67 F. (2d) 71 | 17 |

Statutes **Pages**

| | |
|--|--------|
| Federal Trades Commission Act, Public Law No. 203, 63rd Congress, Section 12 | 23 |
| Title 15 U.S.C. Section 42 | 23 |
| Title 18 U.S.C.A. Section 386 | 10 |
| Title 28 U.S.C. Section 863, 36 Stat. 1167 | 21, 24 |
| 52 Stat. 114 | 23 |

Texts

| | |
|---|----|
| 27 American Jurisprudence, page 621, Section 54 | 16 |
|---|----|

Rules

| | |
|---|----|
| Rules of Civil Appeal, Rule 75 | 21 |
| Rules of Criminal Appeal, Rule 39 | 21 |
| Rules of Criminal Procedure, Rule 42b | 17 |

United States Constitution

| | |
|--|------|
| United States Constitution, Fifth and Sixth Amendments.. | 2, 4 |
|--|------|

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UNITED STATES OF AMERICA,

Appellee.

APPELLANTS' PETITION FOR A REHEARING.

*To the Honorable William Denman, Chief Judge, and
to Honorable Associate Judges Healy and Stephens
of the United States Court of Appeals for the Ninth
Circuit:*

Comes now Chester Walker Colgrove, trading and doing business under the firm name of Colusa Remedy Company, and Colusa Remedy Company, a corporation, appellants, and respectfully petition for a rehearing of the judgment and decision entered and filed herein on August 8, 1949, and as grounds therefor respectfully set forth as follows:

I—THE COURT IN ITS OPINION ERRED IN INFERENTIALLY HOLDING THAT THE EVIDENCE WAS SUFFICIENT TO JUSTIFY THE FINDING AND JUDGMENT OF THE COURT BELOW HOLDING THE DEFENDANTS GUILTY OF CRIMINAL CONTEMPT.

There was a complete failure of proof of any criminal contempt:

(a) There was absolutely no proof that the "directions for use" on the Colusa labels were not adequate.

(b) There was absolutely no proof that the defendants knew these labels to be inadequate.

(c) There was no evidence of any "wilful" disobedience, an indispensable ingredient of criminal contempt.

II—THERE WAS NO SUFFICIENT PLEADING OF ANY CRIMINAL CONTEMPT; THE COURT FAILED IN ITS OPINION TO PASS ON THIS VITAL ISSUE.

III—THE INJUNCTIVE ORDER WAS SO VAGUE AND INDEFINITE AS NOT TO BE THE BASIS OF A CONTEMPT ORDER AND THEREFORE VIOLATED THE FIFTH AND SIXTH AMENDMENTS TO THE U. S. CONSTITUTION.

IV—THE CIRCUIT COURT ERRED IN CONSIDERING MATTERS NOT BEFORE THE TRIAL COURT OR PROPERLY BEFORE THIS COURT.

V—THE COURT FAILED TO RULE ON THE QUESTION OF WHETHER UNDER THE CIRCUMSTANCES OF THIS CASE THERE COULD BE BUT A SINGLE CONTEMPT.

VI—THE COURT BELOW WAS WITHOUT JURISDICTION TO FIND APPELLANTS GUILTY OF CRIMINAL CONTEMPT SINCE NEWSPAPER ADVERTISING, WHICH

FORMED THE BASIS OF THE ALLEGED CONTEMPT, IS EXCLUSIVELY IN THE JURISDICTION OF THE FEDERAL TRADE COMMISSION, AND NOT THE PURE FOOD AND DRUG ACT UNDER WHICH THIS INJUNCTIVE ORDER WAS ISSUED. THIS COURT SHOULD EXPRESSLY PASS UPON THIS SUBJECT.

VII—THE COURT ERRED IN NOT DISCUSSING OR PASSING UPON IN ITS DECISION ALL OTHER IMPORTANT POINTS RAISED ON OUR ORIGINAL APPEAL AND WHICH WE REURGE HERE BY REFERENCE.

INTRODUCTION.

The writers of this petition for a rehearing who appear as of counsel, were not participants until after this court had handed down its decision.

It is only because all counsel feel that there has been a real miscarriage of justice in this instance, and that the case is one which should receive the further consideration of this court, that we have prepared this petition for a rehearing. We most respectfully ask the court to give this petition the same consideration we have given in its preparation.

It is respectfully submitted that a rehearing should be granted, and the judgment below reversed because there was neither a valid pleading nor any proof of a criminal contempt.

THE FACTS AS TO THIS CONTROVERSY.

Before elaborating upon the various legal propositions stated in this petition, we desire briefly to advert to the salient facts in this matter as indisputably shown by the record below:

This entire controversy, with its most severe judgment below, arises out of the simple fact that appellants did not print *on the Colusa labels* the names of certain skin ailments (poison oak, itch, etc.) which were incidentally mentioned in the fine print in the Colusa newspaper advertisements (in quoting from testimonials). We understand from what the government's attorney said (Record p. 53) that he concedes that had these ailments been thus named, the Colusa labels would have been beyond criticism, and not in violation of the injunction below. This very concession, in our humble opinion, completely destroys the government's case and wholly negatives any possibility of a *criminal contempt*! By this concession the government in effect admits that the "directions for use" on the Colusa labels were entirely adequate (which is one of the vital factual issues in this case) since the placing of these names of diseases on the label would not make the directions any different or more adequate.

The second salient aspect of the facts below which we desire to stress, at the outset, is that the lower court's injunction was and is a quite general and indefinite order, and therefore is violative of the Fifth and Sixth Amendments to the U. S. Constitution. It does not spell out any exact or definite standards to guide appellants in their attempt to conform to it. Its wording is admittedly awkward and misleading, so much so that the lower court had to concede:

"The Court. The defendant is technically, literally correct in the literal meaning of the restraining order * * *" (R. 77).

"The Court. I think the injunction should, possibly, have been worded in the disjunctive instead of the conjunctive." (R. 78).

The court then proceeded to find appellants guilty of *criminal contempt* for having obeyed the letter but *not* the spirit of this indefinite and confusing injunction, and proceeded to impose a most severe judgment.

We can think of no better description of this example of judicial wrath than the recent apt statement of Justice Frankfurter in a dissenting opinion in a *civil contempt* case based on a similarly indefinite decree:

"But courts should be explicit and precise in their commands and should only then be strict in exacting compliance. To be both strict and indefinite is a kind of judicial tyranny."¹ (*McComb v. Jacksonville Paper Co.*, February 14, 1949, 93 Law Ed. Advance Opinions, 457, at 462).

I. THE COURT IN ITS OPINION ERRED IN INFERENTIALLY HOLDING THAT THE EVIDENCE WAS SUFFICIENT TO JUSTIFY THE FINDING AND JUDGMENT OF THE COURT BELOW HOLDING THE DEFENDANTS GUILTY OF CRIMINAL CONTEMPT.

(1) The controlling law.

This is a criminal contempt proceeding. The legal principles governing it are strict and well settled:

¹Unless otherwise indicated, all emphasis herein, by italics or otherwise, is ours.

"In a proceeding for criminal contempt, the presumption of innocence must be applied. The burden is on the government to prove the guilt of the defendants beyond a reasonable doubt. There is no shifting of the burden of proof. The defendants cannot be compelled to testify against themselves. *Gompers v. Buck's Stove & Range Co.*, 211 U.S. 418, 444, 31 S. Ct. 492, 55 L. Ed. 797, 34 L.R.A., N.S. 874." (*U. S. v. Balaban*, 26 Fed. Sup. 491, 498.)

"In a contempt proceeding, the government must prove all the essential elements of the offense and guilt beyond a reasonable doubt."

United States v. Resnick, 299 U.S. 207;

Holt v. United States, 218 U.S. 245;

Agnes v. United States, 165 U.S. 36;

Alberte v. United States, 159 F. (2d) 278;

United States v. United Mine Workers, 330 U.S. 258;

Penfield v. Securities and Exchange Commission, 330 U.S. 585;

McComb v. Jacksonville Paper Co., 93 L. Ed. 457.

The following is a succinct summary of the settled law by Judge Stephens in *Raskin v. Superior Court*, 138 Cal. App. 668, 33 P. (2d) 35, 36:

"Contempt is a disobedience of court by acting in opposition to its authority, justice or dignity, and is an offense of a criminal nature which must be supported as other criminal charges are supported and which is subject to the same presumptions."

(2) The proof required herein.

As we read the court's opinion, the crux of the decision seems to be that various skin ailments mentioned in the

advertisements were not included among the four ailments mentioned on the label. Such was not the gravamen of the charge. Leaving aside the contention as to whether the wording of both injunctions was susceptible of the restricted construction placed thereon by appellants, we submit that no other conclusion can be arrived at but one establishing the innocence of appellants of the various charges contained in the information.

Assuming that the ailments named on the label constituted a prescribing, recommending and suggesting of the use of the product for such ailments, and further assuming that the other skin ailments mentioned in the advertising likewise constituted a prescribing, recommending and suggesting of the use of such product for such additional ailments, we are confronted with no different situation than if such additional ailments had been included in and set forth on the label.

If all of these ailments appeared upon the label, then the sole question to be determined was whether the directions in the one instance were specific or in the other instance adequate for the use of the product for such ailments.

The burden of proof as to the inadequacy of such directions at all times was upon the Government. *No evidence was introduced that the directions were neither specific nor adequate for the treatment of all ailments named on the label or referred to in the advertisements.* The absence of such proof constituted a failure to prove any or all of the alleged contempts.

Neither injunction directed that all ailments for which the product was prescribed, suggested or recommended should appear upon the label. The injunctions merely provided that the label should contain specific or adequate directions for its use in the treatment of any ailment for which it was prescribed, recommended and suggested. If the use of the testimonials in the advertisements constituted such prescribing, recommending or suggesting, then the injunctions were fully complied with because the directions were specific and adequate as to the use of the product.

This court can, as the lower court should have done, take judicial knowledge of the fact that the common and accepted means of applying lotions, unguents and ointments is by external application either by hand or by the means of an applicator. However, the burden was not upon appellant to establish that the directions were either specific or adequate for any of the named ailments; this burden was upon the Government and no evidence having been introduced to support this vital element of the Government's charges and the presumption of innocence running in favor of appellant, it should be held that appellant is innocent of the charges.

Lastly, on this point, let us assume that all of the ailments set forth in the advertisements were added to those set forth on the label and that the directions appearing on the label followed such designation of ailments. Under these circumstances, would an order adjudging appellant to be in contempt find support in the mere offering in evidence of the label? Would there not have to be, in

addition to such label, evidence produced by the Government showing that the directions were inadequate? Clearly, the answer to both questions should be plain. The mere introduction of the label would not support the charges contained in the information. The failure of the Government to introduce evidence as to the inadequacy of the directions would constitute a fatal failure of proof.*

The contempt charged below consisted of an alleged failure of appellants to place on the Colusa labels "specific" or "adequate" directions for use of Colusa Oil in *all* the diseases for which it is "prescribed" etc., *in the advertising material of appellants*. In other words, the injunction forbade the shipment in interstate commerce of this Colusa Oil:

"* * * without a label containing adequate directions for the use of such product in the treatment of all * * * diseases for which such product is prescribed, recommended and suggested *in the advertising material* * * * of the defendants * * *" (R. 3).

Now, it indisputably appears in the record below (in fact—in the very criminal information filed by the government to initiate these contempt proceedings) that:

- (1) These Colusa shipments *all bore labels*.

*In arguing the insufficiency of the evidence, we are aware of the stipulation as to facts that was introduced in the lower court. In our opinion this stipulation went no further than relieving the Government from the proof of certain physical facts, such as activities in interstate commerce, defendant's responsibility for the advertisements, etc. The stipulation did not cover ultimate facts that would establish the guilt of defendant as this would be contrary to his plea of not guilty. It was defendant's contention that the labels complied with the injunction (Record 49).

(2) These labels contained "directions for use."

Therefore, it was incumbent upon the government to prove by competent evidence and beyond any reasonable doubt:

(a) That these "directions for use" were *not* adequate for the treatment of the diseases for which Colusa oil was "prescribed", etc. in the advertising material of appellants;

and

(b) That appellants *knew* that these "directions for use" were not adequate.

Criminal contempt requires, of course, proof of a deliberate, that is, a *willful disobedience* of the court's order below. An innocent violation of such decree (due, for example, to a misunderstanding thereof, or otherwise) would not constitute *criminal contempt*. The federal statute on contempt expressly requires this:

"Section 386. *Contempts: When constituting also criminal contempt.* Any person who shall *willfully disobey* any lawful writ, etc."

Title 18 U.S.C.A., Section 386.

The United States Supreme Court has very clearly defined the significance of the word "willful" in such a criminal statute:

"We recently pointed out that 'willful' is a word 'of many meanings, its construction often being influenced by its context.' * * * But 'when used in a criminal statute it generally means an act done with a bad purpose.' Id. 290 U.S. 394, 78 L. Ed. 384, 54 S. Ct. 223. And see *Felton v. United States*, 96 U.S. 699, 24 L. Ed. 875; *Potter v. United States*, 155 U.S.

438, 39 L. Ed. 214, 15 S. Ct. 144; *Spurr v. United States*, 174 U. S. 728, 43 L. Ed. 1150, 19 S. Ct. 812; *Hargrove v. United States* (C.C.A. 5th), 67 F. (2d) 820, 90 A.L.R. 1276. In that event something more is required than the doing of the act proscribed by the statute. Cf. *United States v. Balint*, 258 U.S. 250, 66 L. Ed. 604, 42 S. Ct. 301. An evil motive to accomplish that which the statute condemns becomes a constituent element of the crime. *Spurr v. United States*, supra (174 U.S. 734, 43 L. Ed. 1152, 19 S. Ct. 812); *United States v. Murdock*, supra (290 U.S. 395, 78 L. Ed. 385, 54 S. Ct. 223)."

Screws v. United States, 325 U.S. 91, 161.

(3) Was such proof adduced below?

It was not. The government made no effort to prove either of the aforementioned basic elements. It neither established that these "directions for use" were inadequate; nor did it undertake to show that the appellants knew them to be inadequate.

Furthermore, not only does the record contain no proof of the inadequacy of these "directions for use" but, to the contrary, the government in effect conceded below that these "directions for use" were entirely adequate insofar as the diseases named on the Colusa label are concerned (i.e., psoriasis, eczema, leg ulcers, athlete's foot). As stated above, these particular diseases are the most severe and difficult skin diseases. The other skin ailments (i.e., poison oak, itch, bed sores, etc.) as to which the whole complaint in this case arises, are admittedly relatively minor skin diseases, and to a large degree are but minor manifestations of some of the aforementioned seri-

ous diseases. It would seem quite evident that "directions for use" which are adequate for the aforementioned severe skin diseases, would likewise be entirely adequate in the treatment of these milder and less difficult ailments. Particularly so when it is realized that this oil is applied in exactly the same way in the treatment of all skin ailments (i.e. as directed in these "directions for use").

However, irrespective of whether the record below affirmatively shows that these "directions for use" *are adequate*, the indisputable fact is that *no* proof or showing was made that they were or are *not* adequate. Hence, a vital and indispensable link in the government's case is missing and since the Government conceded that merely by adding the names of the minor skin afflictions to the bottle would have been sufficient compliance, it conceded in effect that the directions were adequate.

So important and essential is this phase, that we beg indulgence to restate it in a somewhat different form. To prove a contempt below, it was incumbent upon the government to establish (beyond any reasonable doubt) the following four salient facts:

Fact (1)—That Colusa Oil was shipped in interstate commerce.

Fact (2)—That in its advertising matter the Colusa Company *prescribed*, recommended and suggested the use of this oil for treatment of certain diseases.

Fact (3)—That the "directions for use" on the label were not "adequate" for use of the oil in the diseases for which it is recommended "in the advertising material" of Colusa.

Fact (4)—That appellants knew these “directions for use” to be inadequate.

A large part of the opinion of this Honorable Court is devoted to a discussion of the point as to whether it can be fairly stated that appellants, in their advertising matter, did “*prescribe, recommend and suggest*” the use of this oil in the treatment of poison oak and the other diseases mentioned in fine print in the testimonials (in the newspaper ads) but not named on either the heading of these advertisements or on the bottle label. We believe that the court’s conclusion that this purely incidental mention of these diseases in the testimonials constituted a “*prescribing*” of this oil for these diseases is subject to serious legal and judicial question. Even the lower court recognized this:

“The defendant is * * * literally correct in the literal reading of the restraining order * * *” (R. 77).

However, we are not now concerned with this phase (relating to Fact (2) above). Assuming for the sake of argument the soundness of the conclusion of this Honorable Court that appellants did “*prescribe, etc.*” Colusa oil for poison oak, etc. (i.e. Fact (2) above), the fact still remains that the record below is completely devoid of *any* proof that the “*directions for use*” were *not* adequate, or appellants *knew* them to be inadequate.

Moreover, insofar as any proof of appellants’ intent or knowledge (i.e. *deliberate or willful violation of the injunction*) is concerned, not only is there *no such proof* but, to the contrary, the undisputed testimony below shows

a sincere and good faith effort on the part of appellants to comply with the rather vague and general writ below. That unrefuted evidence shows (R. 63), without dispute, that immediately after the issuance of this injunction, the defendants, in a conscientious and diligent effort to comply with this order:

(1) Suspended all *intrastate* as well as interstate shipments of Colusa oil (even though the lower Court had, and attempted, no jurisdiction whatsoever over the *intrastate* shipments).

(2) Printed new labels at substantial expense.

(3) Recalled previous shipments of Colusa oil from various states, for re-labelling, even though defendants could have proceeded freely to sell and distribute these pre-injunction shipments in such states, with impunity insofar as this injunction was concerned.

This testimony stands wholly undisputed and unrefuted.

Furthermore, the defendants expressly disclaimed, in the sworn testimony below, any intent to violate this injunction. Mr. Colgrove testified:

“Q. There was no intent on your part at any time to violate this injunction?

A. Positively not.

Q. You did everything you felt that was in your power towards complying with it?

A. I did.” (R. 63.)

And, in connection with this phase as to the “good” or “bad” faith of appellants, we desire to stress the following: The record below plainly shows that appellants *did not believe or understand* that they were “prescribing”

this oil for the several ailments (poison oak, itch, etc.) incidentally mentioned in fine print in the advertisements.

Mr. Colgrove's unrefuted testimony shows that he did not think or understand that such an incidental reference to these diseases constituted a "prescribing" etc. And, as stated above, the lower court agreed that he was literally correct in his reading and interpretation of this injunction.

This being true, it is clear, we respectfully submit, that not only is there an entire absence of proof of "guilty knowledge" or "bad motive" *but the record affirmatively shows at the very most a misunderstanding by the defendants of the scope and effect of this rather ambiguous writ below.* This negatives any criminal contempt.

In other words, even assuming that Mr. Colgrove was wrong (as this Honorable Court says he was) in thinking that he was not *prescribing* for poison oak and these other minor ailments, *still he was acting under a misconception of this order.* Such a misconception, as testified to by him in the lower court (and recognized by the trial court as "literally correct") certainly negatives any "criminal intent" or *deliberate flaunting* of the court's order.

For all of the reasons above reviewed, it is clear, we respectfully submit, that there was no sufficient proof of any *criminal* contempt.

II. THERE WAS NO SUFFICIENT PLEADING OF ANY CRIMINAL CONTEMPT; THE COURT FAILED IN ITS OPINION TO PASS ON THIS VITAL ISSUE.

It is requisite that the information in criminal contempt proceedings contain clear and adequate allegations of all necessary facts, sufficient to show the commission of a criminal contempt including an allegation of wilfulness. *U. S. v. Aberback*, 165 F. (2d) 713; *U. S. v. United Mine Workers of America*, 330 U. S. 258.

It is a cardinal principle of criminal pleading that an indictment or information must allege the facts of the alleged offense *with precision and certainty*, and that vague and indefinite allegations will not suffice. The following text statement epitomizes the many judicial expressions of the aforementioned legal principle, viz.:

“Every material fact and essential ingredient of the offense—every essential element of the offense—must be alleged with precision and certainty, or, as has been stated, every fact which is an element in a *prima facie* case of guilt must be stated in the indictment * * * The offense and the essential elements thereof must be alleged in positive terms, and not by way of recital or mere legal conclusions, unaided by intendment or inference.” (27 American Jurisprudence, p. 621, Sec. 54).

The following are a few of the many cases exemplifying this settled legal principle, viz.:

United States v. United Mine Workers, 330 U. S. 258;

U. S. v. Hess, 124 U.S. 483, 8 S. Ct. 571, 31 L. Ed. 516;

White v. U. S. (C.C.A. Okl. 1933) 67 F. 2d 71;
Jarl v. U. S. (C.C.A. Neb. 1927) 19 F. 2d 891;
Clary v. Commonwealth, 163 Ky. 48, 173 S.W. 171;
Merwin v. People, 26 Mich. 298, 12 Am. Rep. 314;
Collins v. U. S., 253 Fed. 609 (C.C.A. 9);
U. S. v. Morse, 287 Fed. 906;
Harris v. U. S. (C.C.A. Mo.) 104 F. 2d 41;
See Rule 42b, *Rules of Criminal Procedure*.

In most of these cases, the upper court reversed a conviction, after trial below, because of the insufficiency of the indictment or information.

In *U. S. v. Hess* (supra) an indictment charging a scheme was held insufficient, as vague and uncertain, because it failed to specify the particulars of the scheme. The Supreme Court stated therein:

“No essential element of the crime can be omitted without destroying the whole pleading. The omission cannot be supplied by intendment, or implication, and the charges must be made directly, and not inferentially, or by way of recital.” (124 U.S. 486)

In *White v. U. S.* (supra) an indictment under the bankruptcy act for concealing assets was held to be insufficient as vague and uncertain because it failed to specify the assets alleged to have been concealed. In thus invalidating the indictment, the court emphasized the settled rule that:

“Every ingredient of which the offense is composed must be accurately and clearly alleged.” (67 F. 2d 73)

In *Collins v. U. S.* (supra) this Honorable Court, in rejecting an indictment as insufficient, stated:

"The indictment charges that the defendant did willfully make and convey false reports and false statements with intent to interfere with the operation and success of the military forces of the United States. But neither the defendant nor the court is advised as to what the reports and statements were, and the allegation is the sheerest conclusion." (253 Fed. 612)

Application of these settled principles to the information filed in this proceeding.

Applying these settled principles of constitutional law and the rules to the instant case, it is at once apparent, we respectfully submit, that this criminal information was required to contain clear and positive factual allegations showing:

(1) That the "directions for use" (admittedly on the Colusa labels) were not "adequate" in the treatment of the diseases for which Colusa oil was "prescribed" in the advertising material of appellants.

(2) That defendants, at the time they used these labels, *knew* that these "directions for use" were *not* adequate.

Obviously, in such a proceeding, one of the most important phases of such a criminal information would be detailed factual allegations showing wherein or why the "directions for use" are claimed to be inadequate.

There is an entire absence in the Information herein of any such allegations. Neither of said fundamental requisites aforementioned is complied with.

Furthermore, there is not even a general allegation in the Information that defendants "*willfully disobeyed*"

(to borrow the words of the controlling statute) the injunction below.

The only effort to allege a criminal contempt is the following language in Count Three (R. 6) of the Information (which is typical of the language employed in the other counts):

“That the labels on defendants’ product, as shipped to said Schlitz Bros. Drug on July 9, 1947, disregard the requirements of the permanent injunction described in Count I since they fail even to attempt to bear adequate directions for use of the product in the treatment of all ills, conditions and diseases for which the product is prescribed, recommended, and suggested in the advertising material disseminated and sponsored by the defendants.”

It is respectfully submitted that these allegations do not even remotely approach a sufficient pleading of *facts* showing a criminal contempt. At the very most, this allegation is *a pure conclusion of law*.

III. THE INJUNCTIVE ORDER WAS SO VAGUE AND INDEFINITE AS NOT TO BE THE BASIS OF A CONTEMPT ORDER AND THEREFORE VIOLATED THE FIFTH AND SIXTH AMENDMENTS TO THE U. S. CONSTITUTION.

In order for an injunctive order to be valid it must be in no uncertain terms.

Kraus & Bro. v. U. S., 327 U.S. 614 (1946).

Patent omissions could not be omitted by the pleader and supplied by the court.

IV. THE CIRCUIT COURT ERRED IN CONSIDERING MATTERS NOT BEFORE THE TRIAL COURT OR PROPERLY BEFORE THIS COURT.**CONSIDERATION OF MATTERS OUTSIDE THE RECORD.**

In the opening paragraph of its opinion, reference is made to alleged court experiences of these appellants. Reference is made to *United States v. 9 bottles of Colusa Natural Oil*, 78 Fed. Supp. 721. We direct attention to the fact that that case has not become final on appeal and a petition is presently being prepared by eastern counsel for *certiorari* to the United States Supreme Court. Such case not being final could not be considered for any purpose. *Estate of Ricks*, 160 Cal. 467; *Tatum v. Levi*, 3 Pac. (2d) 963, 967. For further interest it is to be noted that the case referred to was not a case involving contempt, either civil or criminal but was a libel action and therefore proceeded on rules in admiralty. We submit that the cited case, still undecided by final court action, should have had no place whatsoever in the consideration by this court of the proceedings in that case. The eastern case was a libel action where a libel had been filed for condemnation of a shipment of nine bottles of Colusa oil and the case was governed by rules similar to those in admiralty. Again, the trial court did not have the eastern case nor any of the facts in that case before it in arriving at its finding of contempt, nor could it properly have considered it as proceedings in the court below were for an alleged violation of its order and not any other order, injunction or decree. An Appellate Court is confined to the evidence of the court below on which the adjudication of guilt was made.

Title 28, Section 863, 36 Stat. 1167, followed by Rule 75 Rules of Civil Appeal and Rule 39 Rules of Criminal Appeal.

Marbury v. Madison, 1 Cranch (U.S.) 137, 175, 2 L. Ed. 60;
Estate of Ricks, 160 Cal. 467;
Tatum v. Levi, 3 Pac. (2d) 963, 967.

We believe prior court experiences of these appellants have prejudiced them in the consideration of this appeal and we submit a rehearing should be granted so that they may have this appeal considered exclusively on the issues here involved.

We submit this part of our petition without amplification as we feel that merely to state the point is sufficient.

V. THE COURT FAILED TO RULE ON THE QUESTION OF WHETHER UNDER THE CIRCUMSTANCES OF THIS CASE THERE COULD BE BUT A SINGLE CONTEMPT.

IF THERE WAS CONTEMPT THERE WAS BUT ONE SINGLE CONTEMPT.

In their appeal, appellants urged as error the finding that they were guilty of eight separate criminal contempts and judgment was imposed on them on eight separate counts. This court has failed to pass upon the issue of whether there were eight contempts or only one contempt.

There was one label on all the bottles. The label did not change. The newspaper advertising was all of the same type and character. We submit every publication

did not make it a separate contempt nor does the fact that advertisements were published in different cities make separate contempts. For an analysis of a similar situation, we refer to *People v. Stephens*, 79 Cal. 428. In that case the defendant was charged with libel. On his acquittal there was an attempt to charge him with other libels. The court held that there was but a single offense.

See also

In re Morford, 137 Cal. App. 662, 667;
State v. King (La.), 17 So. 288.

If there was "willful" disobedience, we submit there was but a single order which was disobeyed. We believe the Supreme Court took this view of the United Mine Workers case. Otherwise, there would have been a separate count filed for each day the miners remained out on strike. We cannot agree that this was the Congressional intent.

It is worthy of passing interest to note in the United Mine Workers case that the defendants were charged with "willful" disobedience and evidence was offered to prove the charge.

VI. THE COURT BELOW WAS WITHOUT JURISDICTION TO FIND APPELLANTS GUILTY OF CRIMINAL CONTEMPT SINCE NEWSPAPER ADVERTISING, WHICH FORMED THE BASIS OF THE ALLEGED CONTEMPT, IS EXCLUSIVELY IN THE JURISDICTION OF THE FEDERAL TRADE COMMISSION AND NOT THE PURE FOOD AND DRUG ACT UNDER WHICH THIS INJUNCTIVE ORDER WAS ISSUED. THIS COURT SHOULD EXPRESSLY PASS UPON THIS SUBJECT.

This court failed to pass upon the question specifically in its opinion as to whether newspaper advertising came within the purview of the Pure Food, Drug and Cosmetic Act. If it did not the court below was without jurisdiction to extend its decree to cover *newspaper* advertising. Advertising material that accompanies the package has been held to be within the scope of the Pure Food and Drug Act. *Kordel v. U. S.*, 93 L. Ed. 73, but advertising in newspapers was specifically omitted from the act and left to the Federal Trade Commission. The Solicitor General, in arguing the case of *Kordel v. U. S.*, 93 L. Ed. 74 and *U. S. v. Urbuteit*, 93 L. Ed. 79, stated to that court that newspaper advertising was not within the purview of the Pure Food and Drug Act. This was left to the Federal Trades Commission, Sec. 12 Federal Trades Commission Act Public Law No. 203, 63rd Congress as amended by 52 Stat. 114; U.S.C. 15:42.

Repeated attempts have been made by the Pure Food Administrator to get Congress to extend its scope to newspaper advertising, but Congress has refused to do so.

The trial court, however, construed its injunction to apply to newspaper advertising, not within the scope of the Act. And this court has, erroneously in its opinion, approved of that extention of the trial court's decree.

The appellants, however, had a right to rely on Congress' determination that "advertising" does not include newspaper advertising but could legally only refer to such advertising material that accompanied the package or article as in the *Urbuteit* and *Kordel* cases.

The court below and this court therefore erroneously applied its decree beyond the subject matter of its jurisdiction or the jurisdiction of the Food and Drug Administrator, and in conflict with the argument of the Solicitor General in the *Urbuteit* and *Kordel* cases.

In *Kordel v. U. S.*, the Supreme Court said (93 L. Ed. 75) :

"A criminal law is not to be read expansively to include what is not plainly within the language of the statute (*U. S. v. Resnick*, 299 U.S. 207, and *Kraus & Bro. v. U. S.*, 327 U.S. 614), since the purpose fairly to apprise men of the boundaries of the prohibited action would then be defeated. *U. S. v. Sullivan*, 332 U.S. 689, 693; *Winters v. Newport*, 333 U.S. 507."

This is a matter of such great importance as to require a rehearing.

VII. THE COURT ERRED IN NOT DISCUSSING OR PASSING UPON IN ITS DECISION ALL OTHER IMPORTANT POINTS RAISED ON OUR ORIGINAL APPEAL AND WHICH WE URGE HERE BY REFERENCE.

"On appeal no new evidence shall be received in the Supreme Court except in admiralty and prize cases." R. S. 698, March 3, 1911. 36 Stat. 1167.

We submit that consideration of acts of another District Court not before the trial court in considering the innocence or guilt of the defendant constitutes taking new evidence. This is forbidden.

We urge all the other points raised in the appeal in this case to which reference is made and we once again ask their consideration. However, we believe the matters above discussed are sufficient to justify further hearing by this court.

CONCLUSION.

It is respectfully submitted that in the interests of substantial justice a rehearing of this matter should be granted.

We pray for rehearing, and reversal of the judgments below and an order directing the court below to dismiss the proceedings.

Dated, September 6, 1949.

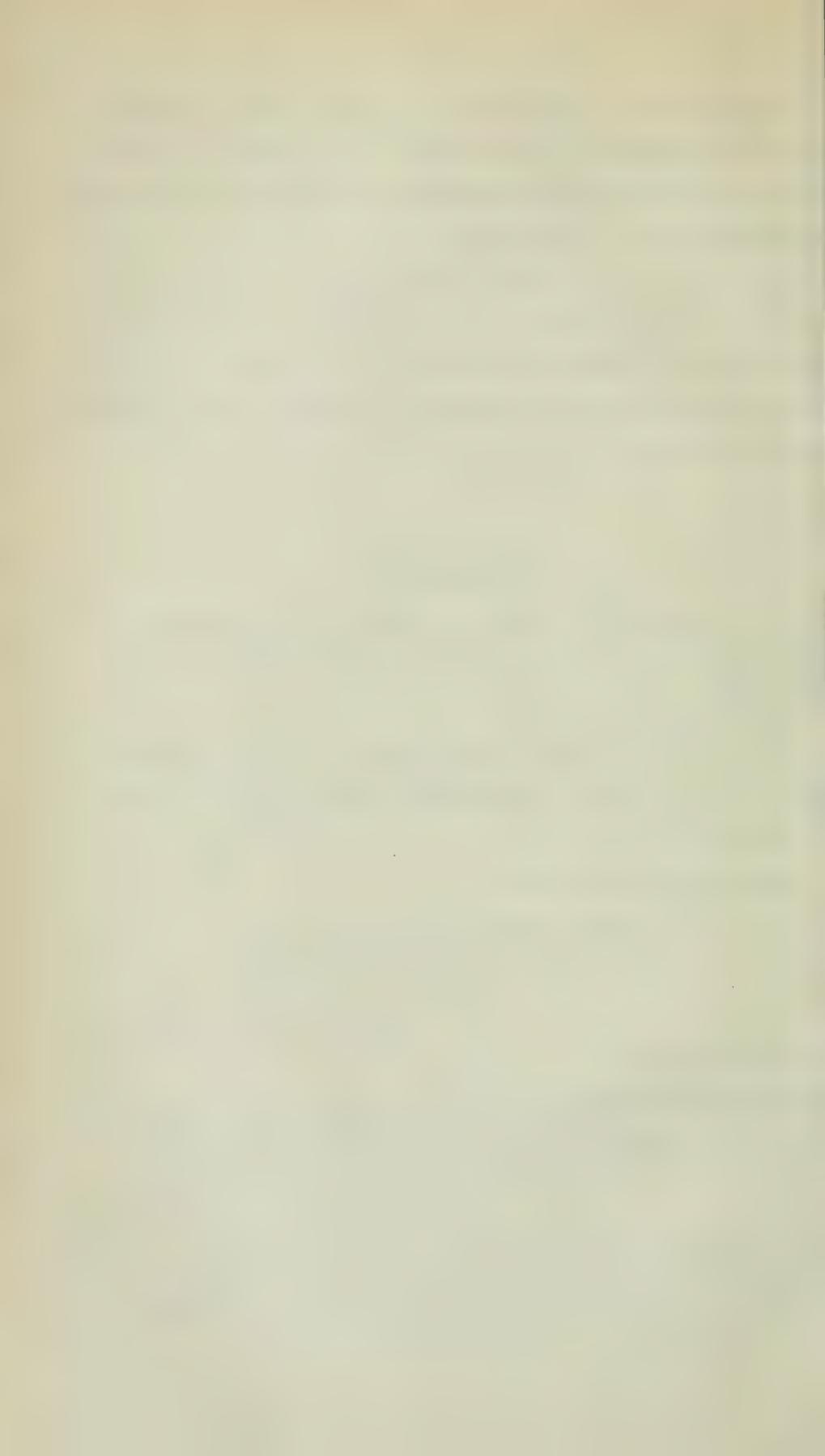
Respectfully submitted,
MORRIS LAVINE,

Attorney for Appellants.

LEO R. FRIEDMAN,

WILLIAM B. ACTON,

Of Counsel.



CERTIFICATE OF COUNSEL.

I hereby certify that I am counsel for appellants and petitioners in the above entitled cause and that in my judgment the foregoing petition for a rehearing is well founded in point of law as well as in fact and that said petition for a rehearing is in good faith and not interposed for delay.

Dated, San Francisco,
September 6, 1949.

MORRIS LAVINE,
*Counsel for Appellants
and Petitioners.*

No. 11834

United States
Circuit Court of Appeals
For the Ninth Circuit.

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
Appellant,

vs.

C. B. SPENCER,
Appellee.

Transcript of Record

Upon Appeal from the District Court of the United States
for the District of Oregon

FILED

APR 27 1948

PAUL P. O'BRIEN,
CLERK

No. 11834

United States
Circuit Court of Appeals
for the Ninth Circuit.

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
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vs.
C. B. SPENCER,
Appellee.

Transcript of Record

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INDEX

[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

| | PAGE |
|---|------|
| Affidavit in Opposition to Petition for Extension of Time..... | 44 |
| Amended Answer for J. W. Maloney and Answer for U. S. A..... | 60 |
| Answer | 46 |
| Appeal: | |
| Appellant's Statement of Points and Designation on | 208 |
| Certificate of Clerk to Transcript of Record on | 97 |
| Defendant's Statement of Points on.... | 87 |
| Designation of Contents of Record on.... | 89 |
| Notice of | 85 |
| Order Extending Time for Filing Rec- ord on | 91 |
| Order Extending Time to File and Docket. | 86 |
| Supplemental Designation of Contents of Record on..... | 90 |
| Appellant's Statement of Points (CCA) on Which He Intends to Rely on Appeal and Designation of Record for Printing..... | 208 |

| INDEX | PAGE |
|---|------|
| Certificate of Clerk to Transcript of Record on Appeal..... | 97 |
| Complaint | 2 |
| Exhibit A—Refund Claim..... | 6 |
| Designation (DC) of Contents of Record on Appeal | 89 |
| Docket Entries | 93 |
| Findings of Fact and Conclusions of Law..... | 67 |
| Conclusions of Law..... | 79 |
| Findings of Fact..... | 67 |
| Judgment | 83 |
| Motion for Preliminary Hearing as to Jurisdictional Defense | 49 |
| Motion of U. S. for Leave to Interplead..... | 59 |
| Motion to Continue Pre-Trial Conference..... | 56 |
| Names and Addresses of Attorneys of Record.. | 1 |
| Notice of Appeal..... | 85 |
| Notice to Enter Name of Randall S. Jones, Associated Counsel | 54 |
| Notice to Produce..... | 54 |
| Order Allowing U. S. to Interplead..... | 60 |
| Order Extending Time for Filing Record on Appeal | 207 |
| Order Extending Time to File and Docket Appeal | 86 |

| INDEX | PAGE |
|--|----------|
| Order (CCA) Extending Time to File..... | 91 |
| Petition for Extension of Time..... | 42 |
| Pre-Trial Order | 50 |
| Reply to Counterclaim of the Interpleader... . | 64 |
| Statement of Points (DC) on Which Defendant Intends to Rely on Appeal..... | 87 |
| Supplemental Designation of Contents of Record on Appeal..... | 90 |
| Transcript of Proceedings..... | 98 |
| Witnesses for Plaintiff: | |
| <i>Powell, Bingham</i> | |
| —direct | 174, 191 |
| —cross | 199 |
| <i>Irvine, J. H.</i> | |
| —direct | 138 |
| <i>Johnson, Frederick</i> | |
| —direct | 170, 181 |
| —cross | 190 |
| <i>Spencer, C. B.</i> | |
| —direct | 115, 140 |
| —cross | 151 |

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OF RECORD**

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Portland, Oregon,

For Appellant.

In the District Court of the United States
For the District of Oregon

No. Civ. 2949

C. B. SPENCER,

Plaintiff,

vs.

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,

Defendant.

COMPLAINT

Comes now the Plaintiff and for cause of suit
against the above named Defendant, alleges:

I.

That at all times mentioned herein Defendant
was and now is the duly appointed, qualified and
acting Collector of Internal Revenue of the United
States for the District of Oregon, having offices
at Portland, Multnomah County, Oregon.

II.

C. B. Spencer, Plaintiff herein, is a resident of
the State of Oregon, and a citizen of the United
States.

III.

Jurisdiction of the within cause rests upon the
provisions of Judicial Code of the United States,
Section 24 as amended (28 USCA sub-division 5,

Section 41), Sections 322 and 3772 of the United States Internal Revenue Code, as amended, and the provisions of Section 23 and 122 of the Internal Revenue Code, as amended: The amount in controversy herein exceeds \$3,000.00.

IV.

That on or about June 15, 1944, Plaintiff filed with Defendant his Amended Income Tax Return for the fiscal year, March 1, 1942, to February 28, 1943, showing a tax liability of \$141,722.80.

That on or about June 15, 1944, Plaintiff filed with the Defendant his Income Tax Return for the fiscal year, March 1, 1943, to February 29, 1944, showing a tax computation of \$43,588.18, and a combined income and victory [1*] tax liability of the plaintiff in the sum of \$152,619.84 for the fiscal years ended Feb. 28, 1943, and Feb. 29, 1944.

That thereafter, and by reason of the provisions of Section 6 (c) 2 of the Current Tax Payment Act of 1943, as amended by Section 506 of the Revenue Act of 1943, Plaintiff paid to Defendant the sum of \$76,107.40 on his Return for the fiscal year ended February 28, 1943, and \$76,297.91 on his Declaration of Estimated Tax for his fiscal year ended February 29, 1944, and \$214.53 on his final Individual Tax Teturn for the fiscal year ended February 29, 1944, being payment in full for the fiscal years ended February 28, 1943, and February 29, 1944.

* Page numbering appearing at foot of page of original certified Transcript of Record.

V.

That during Plaintiff's fiscal year, March 1, 1944, to February 28, 1945, Plaintiff suffered a net operating loss in the amount of \$127,052.55: That of this loss the sum of \$109,910.96 represents a "net operating loss-carry back" as defined by Section 122 of the Internal Revenue Code as amended: That said net operating loss was incurred by Plaintiff in the operation of a business regularly carried on by him.

VI.

That thereafter on or about April 21, 1945, Plaintiff duly filed with the Commissioner of Internal Revenue his Claim for the refund of taxes illegally collected and retained. That said Claim was, in all respects, in due and proper form and petitioned for the refund of the sum of \$93,565.04, being the excess amount of taxes paid by Plaintiff for Plaintiff's fiscal year, March 1, 1942, to February 28, 1943, above the amount of tax due for said year by virtue of Plaintiff's net operating loss carry-back suffered during Plaintiff's fiscal year, March 1, 1944, to February 28, 1945. A copy of said Refund Claim is attached hereto and denominated "Exhibit A" and is made a part hereof as if duly set forth in this paragraph.

VII.

That more than six months have expired since the filing of the above described Claim for Refund, and the Commissioner has failed and refused to allow or to reject said Claim.

VIII.

That on or about the 21st day of April, 1945, plaintiff filed with the defendant an individual income tax return for the fiscal year ended Feb. 28, 1945, [2] showing no tax liability against the plaintiff for said fiscal year and in which return plaintiff claimed a net loss from his business for the said fiscal year in the sum of \$127,052.25.

Wherefore, Plaintiff prays for judgment against the Defendant in the sum of \$93,565.04, together with interest as provided by law, and together with his costs and disbursements incurred herein.

/s/ ROBT. T. JACOB.

/s/ JEROME S. BISCHOFF.

Counsel for Plaintiff.

[Endorsed]: Filed October 27, 1945.

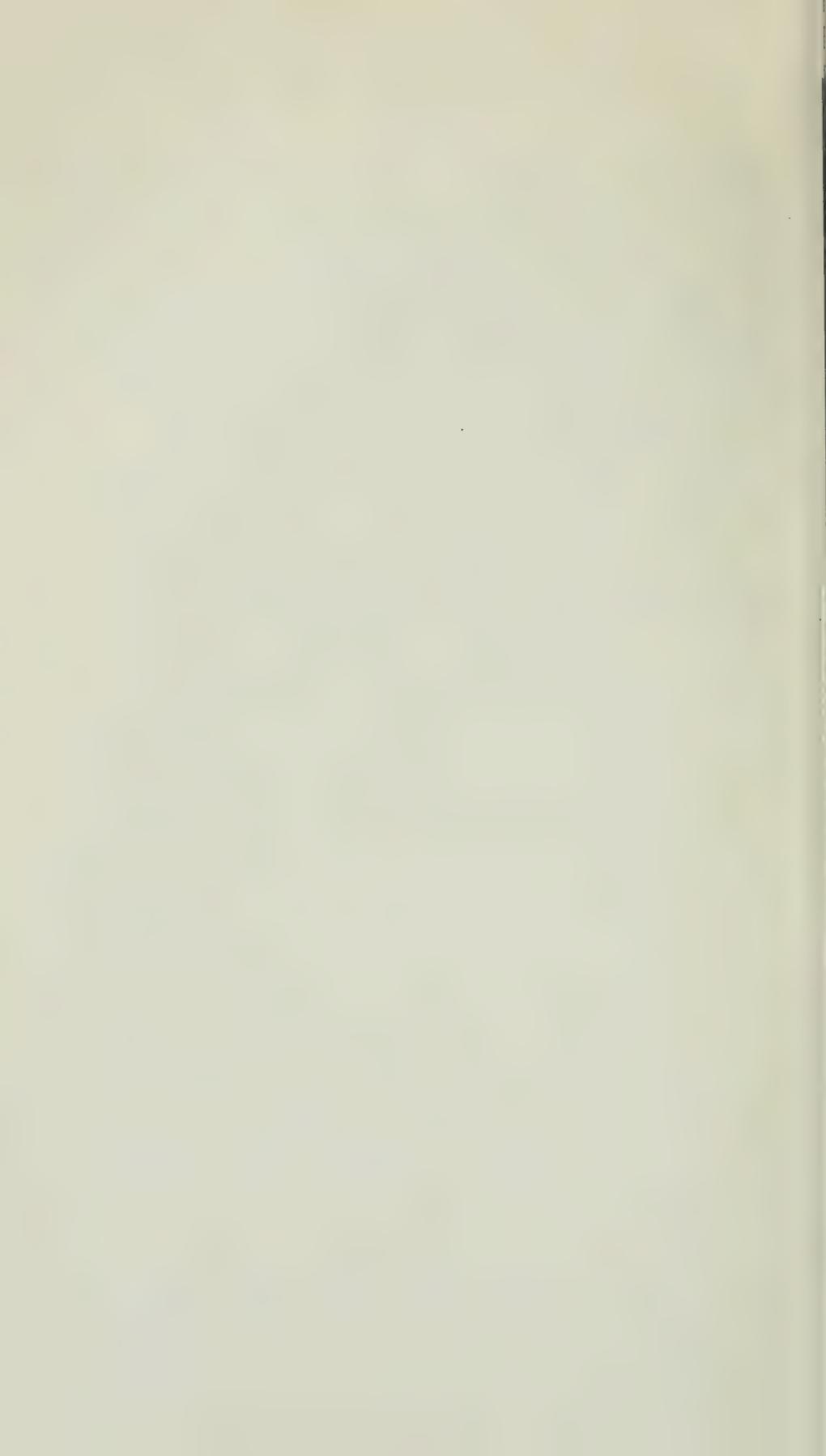


EXHIBIT "A"
CLAIM

TO BE FILED WITH THE COLLECTOR WHERE ASSESSMENT WAS MADE OR THE JUDGE

The Collector will indicate in the block below the kind of claim filed, and file in the certificate the return date.

Return to Tax Bearer or Crossover.
 Return of Amount Paid for Stamps Unused, or Used as Basis on Income.
 Assessment or Tax Assessed (not applicable to estate or income taxes).

NAME OF SPENCER
ADDRESS OF Holbrook

COLLECTOR
Date _____

Name of taxpayer or
purchaser of stamps C. B. SPENCER

Business address 835 Oak Street Salem Oregon
(Name) (City) (State)

Residence _____

The deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer and that the facts given below are true and complete:

District in which return (if any) was filed Portland, Oregon

Period (if for income tax, make separate form for each taxable year) from March 1, 1942 to February 1943

Character of assessment or tax Federal Income Tax

Amount of assessment, \$ 161,722.80; dates of payment Oct. 5, 43; Nov. 15, 43; Feb. 15,

Date stamps were purchased from the Government

Amount to be refunded \$ 93,56

Amount to be abated (not applicable to income or estate taxes) \$

The time within which this claim may be legally filed expires, under Section 322 of the Revenue Act
on May 15, 1943

The deponent verily believes that this claim should be allowed for the following reasons:



SEE ATTACHED

(Attach letter-size sheets if space is not sufficient)

Swear to and subscribed before me this

Signed (s) C. B. SPENCER

21st day of April 1943

(s) DOROTHY ORR
(Signature of officer administering oath)

Notary Public for Oregon
My com exps 10-23-45

(SEE INSTRUCTIONS ON REVERSE SIDE)

"EXHIBIT A"

CERTIFICATE

I certify that an examination of the records of this office shows the following facts as to the assessment and payment of the tax: (Show, in the ninth column, by symbols "Pd.", "Ab.", or "Cr.", the nature of each entry in the ninth column.)

I certify that the records of this office show the following facts as to the purchase of stamps:

Collector of Internal Revenue.

COMMITTEE ON CLIMATE

Amount claimed... \$.....

Amount allowed... \$.....

Amount rejected 3

INSTRUCTIONS

1. The claim must set forth in detail and under oath each ground upon which it is made, and facts sufficient to support the claim, name of the cause basis thereof.
2. The claim should be sworn to by the taxpayer, if possible. Whenever it is necessary to have the claim executed by an attorney, agent, or behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent or attorney to sign the claim on behalf of the taxpayer shall accompany the claim. The oath will be administered without charge by any notary, deputy notary, or internal revenue agent.
3. If a return is filed by an individual and a refund claim is filed later by a legal representative of the decedent, certified copies of the lottery testator, letters of administration, or other evidence must be annexed to the claim, to show the name, address, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary that the latter is still acting.
4. Where the taxpayer is a corporation, the claim shall be signed with the corporate name, followed by the signature and title of the person authorized to sign for the corporation.

SCRAMBLE OF GAINS AND LOSSES

FROM SALES OR EXCHANGES OF (1) CAPITAL ASSETS AND (2) PROPERTY OTHER THAN CAPITAL ASSETS

TO BE FILED WITH THE COLLECTOR OF INTERNAL REVENUE WITH FORM 1040

For Calendar Year 1944

Entered upon Inventory March 1, 1944, and ended Feb. 28, 1945.

The Instrumental Effect

A. A. WINGER & H. S. SPENCER PACKING COMPANY

135 Oak Street, Salina, Kansas

(1) CAPITAL ASSETS

| 1. Description | 2. Present value | 3. Current market price | 4. Expression of cash and non-cash assets contributed to acquire interest or March 1, 1945 | 5. Depreciation allowed (or otherwise) since acquisition or March 1, 1945 (attach schedules) | 6. Gain or loss (column 1 less column 7 less the sum of columns 3 and 4) | 7. Gain or loss to be taken into account |
|-----------------------|-------------------------|--------------------------------|---|---|---|---|
| Mr. Roy Van | Mr. Roy Van | | | | | |

CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS

Total non-short-term capital gains or loss (enter in Line 1, column 3 of summary below) -

1

LONG-TERM CAPITAL GAIN AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS

| | | | | | | | | | | | | | |
|----------|--------|-------|-------|----|-------|----|------|----|------|----|----|---------|----|
| Mon Mach | 939-40 | 18-44 | 5033 | 70 | 4932 | 68 | 2033 | 00 | 2135 | 10 | 50 | \$ 1067 | 55 |
| Crates | 1942-3 | 1944 | 13306 | 99 | 8054 | 50 | 2792 | 71 | 8045 | 20 | 50 | 4022 | 60 |
| Plant | 1943 | 1944 | 70000 | 00 | 68608 | 53 | 5569 | 62 | 6961 | 09 | 50 | 3480 | 54 |

Total net long-term capital gain or loss (enter in line 2, column 3 of summary below)

10

SUMMARY OF CAPITAL GAINS AND LOSSES

| SUMMARY OF CAPITAL GAINS AND LOSSES | | | | | | | |
|--|--|----------|---|----------|---|----------|-----|
| L Capital gains and losses (attach statement) | 3. Net gain or loss to be taken into account from column 10, above | | 4. Net gain or loss to be taken into account from partnerships and common trust funds | | 5. Total net gain or loss taken into account in columns 2, 3, and 4 of this summary | | |
| | (a) Gain | (b) Loss | (a) Gain | (b) Loss | (a) Gain | (b) Loss | |
| Net short-term capital gain or loss | 3 | 3 | 3 | 3 | 3 | \$ | |
| Net long-term capital gain or loss | 3 | 8570 | 698 | 3 | 3 | 8570 | 693 |
| Net gain in column 5, lines 1 and 2. (Enter on line 1, Schedule D, page 3, Form 1040) | | | | | 9 | 8570 | 69 |
| Net loss in column 5, lines 1 and 2. (The amount to be entered on line 1, Schedule D, page 3, Form 1040, is (1) this item or (2) short-term, as adjusted amounts, if tax is paid on part of the item.) | | | | | | | |

Indicate the amount of each item in columns 2, 3, 4, and 5. (Enter on line 1, Schedule D, page 3, Form 1040).

loss in columns 5, lines 1 and 2. (The amount to be entered on line 1, Schedule D, page 3, Form 1040, is (1) this item or (2) net income, or adjusted gross income if tax is computed by use of the tax table on page 2, Form 1040, computed without regard to capital gains or losses, or (3) \$1,000, whichever is smaller.)

— 1 —

COMPUTATION OF ALTERNATIVE TAX

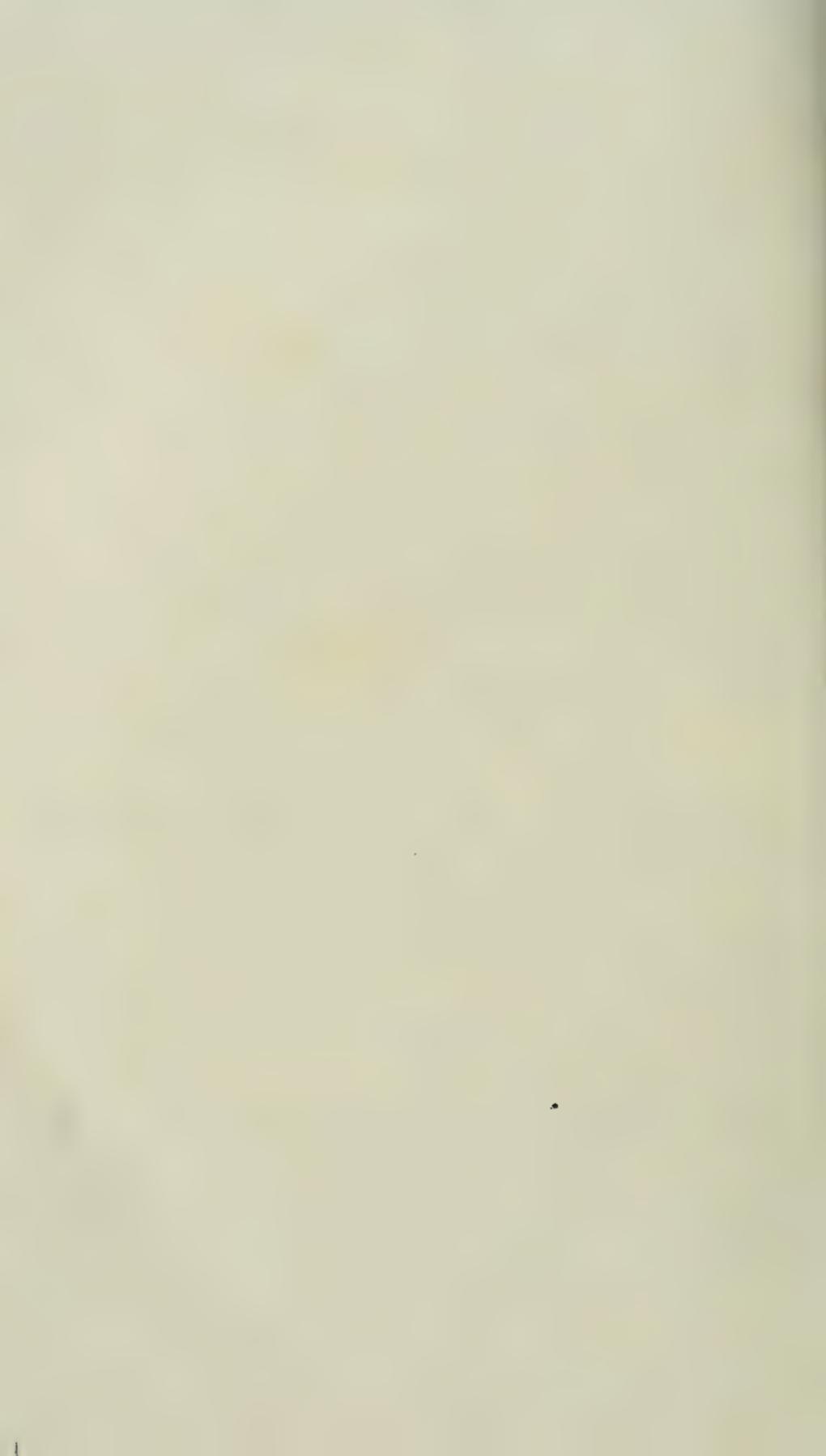
The only **Form 1040** or **Form 1040A** which contains capital gains or losses, and short-term capital loss, and line 5, page 4, Form 1040, exceeds \$16,000.

| | | |
|--|----|--|
| Net income (line 3, page 4, Form 1040). | \$ | |
| Less net long-term capital gains over net short-term capital loss (line 2, column 5 (a), less line 1, column 5(b), of currency shown). | \$ | |
| Net long-term capital gain (line 1 less line 2). | \$ | |
| Net short-term capital gain (line 4, page 4, Form 1040). | \$ | |
| Gains (profits) and losses. | \$ | |
| Loss on line 3. (See Surplus Table in Form 1040.) | \$ | |
| Net long-term capital gain (line 3, above). (If partially taxable, reduce by amount on Tax Computation Worksheet on page 4 of Form 1040 Instructions.) | \$ | |
| Net short-term capital gain (line 4, page 4, Form 1040). | \$ | |
| Amount subject to normal tax. | \$ | |
| 10. Normal tax (3% of line 9). | \$ | |
| 11. Partial tax (line 6 plus line 10). | \$ | |
| 12. 30% of line 2. | \$ | |
| 13. Alternative tax (line 11 plus line 12). | \$ | |
| 14. Total normal tax and surtax (line 6 plus line 10, page 4, Form 1040). | \$ | |
| 15. Tax liability (line 13 or line 14, whichever is the lower). (Enter on line 11, page 4, Form 1040.) | \$ | |

⑩ PROPERTY OTHER THAN CAPITAL ASSETS

Total net gain (or loss) (enter on line 2, Schedule D, page 3, F, no. 1040).

If any item in this schedule was acquired by you otherwise than by purchase, attach a statement explaining how acquired.



INSTRUCTIONS

(Reference are to the Internal Revenue Code)

GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS AND OTHER PROPERTY.—Report totals in schedule on other side.

"Capital assets" defined.—The term "capital assets" means all property held by the taxpayer (whether or not connected with his trade or business) but does NOT include—

- (a) stock in trade or other property of a kind properly includable in his inventory if on hand at the close of the taxable year;
- (b) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
- (c) property used in the trade or business of a character which is subject to the allowance for depreciation provided in section 23(1);
- (d) real property used in the trade or business of the taxpayer;
- (e) an obligation of the U. S. or any of its possessions or of a State or Territory, or of any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

If the total of the distribution to which an employee is entitled under an employees' pension, bonus, or profit-sharing plan meeting the requirements of section 165 (a) is received by the employee in one taxable year, on account of the employee's separation from the service, the aggregate amount of such distributions, to the extent it exceeds the amounts contributed by the employee, shall be treated as a gain from the sale or exchange of a capital asset held for more than 6 months. A capital gain dividend, as defined in section 362 (relating to tax on regulated investment companies), shall be treated by the shareholder as gains from the sale or exchange of capital assets held for more than 6 months.

For special treatment of gains and losses from involuntary conversion, and from sale or exchange of certain property used in the trade or business, see section 117 (j).

For special treatment of gain and loss upon the cutting of timber, or upon the disposal of timber under a contract by which the owner retains an economic interest in such timber, see section 117 (k).

Kind of property listed.—State following facts: (a) For real estate, location and description of land and improvements; (b) for bonds or other evidences of indebtedness, name of issuing corporation, particular issue, denomination and amount; and (c) for stocks, name of corporation, class of stock, number of shares, and capital changes affecting basis (including nontaxable distributions).

Basis.—In determining gain or loss in case of property acquired after February 28, 1913, use cost, except as otherwise provided in section 113. In determining GAIN in case of property acquired before March 1, 1913, use the cost or the fair market value as of March 1, 1913, adjusted as provided in section 113 (b), whichever is greater, but in determining LOSS use cost so adjusted.

Losses on securities becoming worthless.—If (a) shares of stock become worthless during the year or (b) corporate securities with interest coupons or in registered form become

worthless during the year, and are capital assets, the loss therefrom shall be considered as from the sale or exchange of capital assets as of the last day of such taxable year.

Nonbusiness debts.—If a debt, other than (a) a debt evidenced by a corporate security with interest coupons or in registered form and (b) a debt the loss from the worthlessness of which is incurred in the trade or business, becomes totally worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. Enter such loss in column 10 of schedule of short-term capital gains and losses on other side.

Classification of capital gains and losses.—The phrase "short-term" applies to gains and losses from the sale or exchange of capital assets held for 6 months or less; the phrase "long-term" to capital assets held for more than 6 months.

"Wash sales" losses.—Losses from the sale or other disposition of stocks or securities are not deductible (unless sustained in connection with the taxpayer's trade or business), if, within 30 days before or after the date of sale or other disposition, the taxpayer has acquired (by purchase or by an exchange upon which the entire amount of gain or loss was recognized by law), or has entered into a contract or option to acquire, substantially identical stock or securities.

Losses in transactions between certain persons.—No deduction is allowable for losses from sales or exchanges of property directly or indirectly between (a) members of a family, (b) a corporation and an individual owning more than 50 percent of its stock (liquidations excepted), (c) a grantor and fiduciary of any trust, or (d) a fiduciary and a beneficiary of the same trust.

Nondeductible losses.—Losses from the sale or exchange of property are not deductible unless they are incurred in trade or business or in transactions entered into for profit.

LIMITATION ON ALLOWABLE CAPITAL LOSSES.—Losses from sales or exchanges of capital assets shall, if otherwise allowable, be allowed only to the extent of the gains from such sales or exchanges, plus either (a) the net income, or adjusted gross income if the tax is computed by use of the tax table on page 2 of Form 1040, computed in either case without regard to capital gains and losses, or (b) \$1,000, whichever is smaller. However, a net capital loss as defined in section 117 (a) (11) may be carried over to each of the five succeeding taxable years and treated as a short-term capital loss to the extent not allowed as a deduction against any net capital gains of any taxable years intervening between the taxable year in which the net capital loss was sustained and the taxable year to which carried. The amount of the net capital loss carry-over may not be included in computing a new capital loss of a taxable year which can be carried forward to the next five succeeding taxable years.

ALTERNATIVE TAX.—If the net long-term capital gain exceeds the net short-term capital loss, a taxpayer with surtax net income exceeding \$16,000 shall compute the alternative tax (see computation of alternative tax on other side). The alternative tax, if less than the normal tax and surtax computed on page 4 of Form 1040, shall be his tax liability.

Do not itemize deductions if— (1) You determine your tax from the tax table on page 2, or
 (2) Your total income is \$5,000 or more and you claim the \$500 standard deduction.
 If husband and wife living together at end of year file separate returns and one itemizes deductions, the other must file his or her return on Form 1040, and must also itemize deductions.

DEDUCTIONS

Describe deductions and state to whom paid. If more space is needed, list deductions on separate sheet of paper and attach to this return.

| | Amount |
|---|-----------------|
| Itemized Deductions | \$ _____ |
| Allowable Contributions (not in excess of 15 percent of item 5, page 1) | \$ _____ |
| Total Interest | \$ _____ |
| Total Taxes | \$ _____ |
| Total Allowable Losses (not compensated by insurance or otherwise) | \$ _____ |
| Net Expenses (not compensated by insurance or otherwise) | \$ _____ |
| Enter 5 percent of item 5, page 1, and subtract from Net Expenses | \$ _____ |
| Allowable Medical and Dental Expenses. See Instruction for limitation | \$ _____ |
| Total Miscellaneous Deductions | \$ _____ |
| TOTAL DEDUCTIONS | \$ _____ |

TAX COMPUTATION—FOR PERSONS NOT USING TAX TABLE ON PAGE 2

| | |
|---|-----------------------|
| Enter amount shown in item 5, page 1. This is your Adjusted Gross Income | (\$118,450) (66) |
| Enter DEDUCTIONS (if deductions are itemized above, enter the total of such deductions; if adjusted gross income (line 1, above) is \$5,000 or more and deductions are not itemized, enter the standard deduction of \$500) | Actual \$118,450 (66) |
| Subtract line 2 from line 1. Enter the difference here. This is your Net Income | 1,000 (66) |
| Enter your Surtax Exemptions (\$500 for each person listed in item 1, page 1) | 0 (66) |
| Subtract line 4 from line 3. Enter the difference here. This is your Surtax Net Income | 1,000 (66) |
| Use the Surtax Table in instruction sheet to figure your Surtax on amount entered on line 5. Enter the amount here | 0 (66) |
| Copy the figure you entered on line 3, above. (If line 3 includes partially tax-exempt interest, see Tax Computation Instructions) | (\$118,450) (66) |
| Enter your Normal-Tax Exemption (\$500 if return includes income of only one person; otherwise see Tax Computation Instructions) | 200 (66) |
| Subtract line 7 from line 6, and enter the difference here | 0 (66) |
| Enter here 3 percent of line 9. This is your Normal Tax | 0 (66) |
| Add the figures on lines 6 and 10, and enter the total here. (If alternative tax computation is made on separate Schedule D, enter here tax from line 15 of Schedule D) | 0 (66) |
| If you used the \$500 standard deduction in line 2, disregard lines 12, 13, & 14, and copy on line 15 the same figure you entered on line 13 | 0 (66) |
| Enter here any income tax payments to a foreign country or U. S. possession (attach Form 1116) | \$ _____ |
| Enter here any income tax paid at source on tax-free covenant bond interest | \$ _____ |
| Add the figures on lines 12 and 13 and enter the total here | \$ _____ |
| Subtract line 14 from line 11. Enter the difference here and in item 6, page 1. This is your tax | \$ _____ |



If you like this table, tear off this page and file only pages 1 and 3.

TAX TABLE—FOR INCOMES UNDER \$1,000

With all the shaded columns below will you find the box covering the total income you entered in Item 5, page 1. Then read across to the column headed "Number of persons".

SPECIAL RULE FOR HUSBAND AND WIFE

If Item 5, page 1, includes the incomes of both husband and wife, reduce the tax you found in the table by 3 percent of the smaller of the two incomes but not by more than \$15. For an example, see last paragraph of page 2 of Instructions.

UNITED STATES
INDIVIDUAL INCOME TAX RETURNPage 1
1942

OPTIONAL FORM 1040A MAY BE FILED INSTEAD OF THIS FORM IF GROSS INCOME IS REPORTED ON THE CASH BASIS FOR THE CALENDAR YEAR, IS NOT MORE THAN \$100, AND CONSISTS WHOLLY OF SALARIES, WAGES, OTHER COMPENSATION FOR PERSONAL SERVICES, DIVIDENDS, INTEREST, AND RENTALS.

FOR CALENDAR YEAR 1942or fiscal year beginning 3-1, 1942, and ending 2-28, 1943

PRINT NAME AND ADDRESS PLAINLY. (See Instruction C)

C. B. SPENCER dba Spencer Packing Company

(Name) (Use given names of both husband and wife, if this is a joint return)

835 Oak Street(Street and number, or rural route) Salem Marion Oregon

(Post office) (County) (State)

Fruit Canning

(Occupation) (Serial taxpayer number, if any)

(Name and address of employer)

(Do not use these spaces)

File
CodeSerial
No.

Date

(Cashier's Stamp)

Cash—Check—M. O.

First Payment

3

(If more than one employer, attach statement showing name and address and amount received from each)

| Item and description No. | INCOME | Amount | Deductible Expenses (Attach Itemized Statement) | | | |
|--|--------|--------|--|----|---------|---------------|
| 1. Salaries and other compensation for personal services, \$ | | \$ | | | | |
| 2. Dividends | | | | | | |
| 3. Interest on bank deposits, notes, etc. | | | | | | |
| 4. Interest on corporation bonds, etc. | \$ | \$ | Less amortizable land premium | | | |
| 5. Interest on Government obligations, etc.: | | | | | | |
| (a) From line (h), Schedule A | \$ | \$ | | | | |
| (b) From line (i), Schedule A | \$ | \$ | | | | |
| 6. Rents and royalties. (From Schedule D) | | | | | 506 | 24 |
| 7. Annuities | | | | | | |
| ITEMS 8, 9, AND 10, BELOW (AND PAGES 3 AND 4) NEED NOT BE CONSIDERED UNLESS YOU HAVE INCOME (OR LOSSES) IN ADDITION TO ITEMS ABOVE. | | | | | | |
| 8. (a) Net gain (or loss) from sale or exchange of capital assets. (From Schedule F) | | | | | | |
| (b) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule C) | | | | | | |
| 9. Net profit (or loss) from business or profession. (From Schedule H) | | | | | 192,350 | 07 |
| (Statistical receipts, from line 1, Schedule H, \$ | | | | | | |
| 10. Income (or loss) from partnerships; fiduciary income; and other income. (From Schedule I) | | | | | | |
| Total income in items 1 to 10 | | | | | | \$ 192,856 31 |
| DEDUCTIONS | | | | | | |
| 11. Contributions paid. (Explain in Schedule C) | | | | \$ | 200 | 00 |
| 12. Interest. (Explain in Schedule C) | | | | | 126 | 32 |
| 13. Taxes. (Explain in Schedule C) | | | | | 1,357 | 80 |
| 14. Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule C) | | | | | | |
| 15. Bad debts. (Explain in Schedule C) | | | | | | |
| 16. Other deductions authorized by law. (Explain in Schedule C) | | | | | | |
| Total deductions in items 12 to 17 | | | | | | 1,684 12 |
| Net income (item 11 minus item 16) | | | | | | \$ 191,172 19 |

COMPUTATION OF TAX

| | | | |
|---|---------------|---|---------------|
| 1. Net income (item 19 above) | \$ 191,172 19 | 27. Normal tax (6% of item 26) | \$ 11,272 33 |
| 2. Less: Personal exemption. (From Schedule D-1) | \$ 1200 00 | 28. Surtax on item 23. (See Instruction 21) | \$ 130,450 47 |
| 3. Credit for dependents. (From Schedule D-2) | 700 00 | 29. Total (item 27 plus item 28) | \$ 141,722 80 |
| 4. Balance (minus net income) | \$ 189,272 19 | 30. Total tax (item 29 or line 16, Schedule F) | \$ 141,722 80 |
| 5. Less: Item 5 (a) above | \$ | 31. Less: Income tax paid at source | \$ |
| Earned income credit. (From Schedule E-1 or E-2) | 1400 00 | 32. Income tax paid to a foreign country or U.S. possessions. (Attach Form 1166.) | |
| 6. Balance subject to normal tax | \$ 187,872 19 | 33. Balance of tax (from 30 minus items 31 and 32) | \$ 141,722 80 |

I/We declare, under the penalties of perjury, that this return (including any accompanying schedules and statements) has been examined by me/us, and to the best of my/our knowledge and belief is a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued under authority thereof.

(a) GARTHE BROWN

6-15-44

(Date)

ROBT. T. JACOB

(Name of law or employee, if any)

(a) C. B. SPENCER

(Signature of taxpayer)

6-15-44

(Date)

(If this is a joint return (not made by agent), it must be signed by both husband and wife). A return made by an agent must be accompanied by power of attorney. (See Instruction 29)

10-2540-1

Schedule A.—INTEREST ON GOVERNMENT OBLIGATIONS, ETC. (See Instruction 5)

| 1. Obligations or securities | 2. Amount owned at end of year including your proportionate share of such obligations held by estates, trusts, partnerships, or common trust funds | 3. Interest received or accrued during the year | 4. Amount of principal, interest or accrued which is exempt from taxation | 5. Interest on amount in column 1 minus column 4 and dividends subject to service tax |
|---|--|---|---|--|
| (a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions. | \$ | \$ | All | \$ |
| (b) Obligations issued prior to March 1, 1941, under Federal Farm Loan Act, or under such Act as amended. | | | All | \$ |
| (c) Obligations of United States issued on or before September 1, 1917. | | | All | \$ |
| (d) Treasury Notes issued prior to December 1, 1940, Treasury Bills and Treasury Certificates of Indebtedness issued prior to March 1, 1941. | | | All | \$ |
| (e) United States Savings Bonds and Treasury Bonds issued prior to March 1, 1941. | | | 65,000 | \$ |
| (f) Obligations of instrumentalities of the United States (other than obligations to be reported in (b) above) issued prior to March 1, 1941. | | | None | \$ |
| (g) Dividends on share accounts in Federal savings and loan associations in case of shares issued prior to March 23, 1942. | ***** | ***** | ***** | \$ |
| (h) Total (enter as item 5 (a), page 1). | | | | \$ |
| (i) Treasury Notes issued on or after December 1, 1940, and obligations issued on or after March 1, 1941, by the United States or any agency or instrumentality thereof (enter amount of interest as item 5 (b), page 1). | | | Amount owned at end of year | Interest received or accrued during the year (add columns 2 and 3 for normal tax and certain |

Schedule B.—INCOME FROM RENTS AND ROYALTIES. (See Instruction 6)

| 1. Kind of property | 2. Amount | 3. Depreciation or depletion (attach schedule) | 4. Repair (explain below) | 5. Other expenses (itemize below) | 6. Net profit (column 2 minus 3, 4, and 5) (enter as item 6, page 1) |
|---------------------|------------|--|---------------------------|-----------------------------------|--|
| Farm | \$ 4412.18 | \$ 508.50 | \$ - | \$ 3397.44 | \$ 506.24 |
| share crop | | | | | |

Explanation of deductions claimed in columns 4 and 5. Labor 474.65 - Interest 1025.00 - Taxes 1642.53
Misc. Supplies and labor 255.26

Schedule C.—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 12, 13, 14, 15, 16, AND 17

| 1. Item No. | 2. Explanation | 3. Amount | 1. Item No. (Continued) | 2. Explanation (Continued) | 3. Amount (Continued) |
|--------------|----------------|------------|-------------------------|----------------------------|-----------------------|
| State Income | | \$ 1186.84 | | | \$ |
| Real Estate | | \$ 170.96 | | | \$ |
| | | \$ 1357.80 | | | \$ |

Schedule D.—EXPLANATION OF CREDITS CLAIMED IN ITEMS 21 AND 22. (See Instructions 21 and 22)

| (1) Personal Exemption | | | (2) Credit for Dependents | | |
|---|---|----------------|------------------------------------|----------------------------------|----------------|
| Status | Number of months during the year in each status | Credit claimed | Name of dependent and relationship | Number of months during the year | Credit claimed |
| Single, or married and not living with husband or wife, and not head of family. | \$ | | Daughter 11 yrs. | 12 | \$ 350.00 |
| Married and living with husband or wife. | 12 | \$ 1200.00 | Mother 79 yrs. | 12 | \$ 350.00 |
| Head of family (explain below). | | | | | |

Reason for support, if 12 months or over. Unable to support self due to age.

Schedule E.—COMPUTATION OF EARNED INCOME CREDIT. (See Instruction 25)

| (1) If your net income is \$3,000 or less, use only this part of schedule | (2) If your net income is more than \$3,000, use only this part of schedule |
|---|---|
| Net income (item 19, page 1) \$ | Earned net income (not more than \$14,000) \$ |
| Earned income credit (10% of net income, above) \$ | Net income (item 19, page 1) \$ |

| | |
|---|--|
| QUESTIONS | |
| 1. Did you file a return for any prior year? <u>Yes</u> If no, what was the latest year? <u>1941</u> . To which Collector's office was it sent? <u>Portland, Oregon</u> . | 4. Was the rate of your salary or wages increased or decreased during 1942, and before the end of year, made public? <u>No</u> |
| 2. If separate return was made for the current year, state: | 5. Did you receive during your taxable year any income other than taxable other than interest reported in Schedule A (see page 19)? <u>No</u> If no, attach schedule showing amount of each income. |
| (a) Name of husband or wife _____ | 6. Did you at any time during your taxable year own or have a stock of a foreign corporation or a personal interest fixed by section 301 of the Internal Revenue Code? Attach statement required by Instruction K. |
| (b) Personal exemption, if any, claimed thereon _____ | |
| (c) Collector's office to which it was sent _____ | |
| 3. Check whether this return was prepared on the <input checked="" type="checkbox"/> or <input type="checkbox"/> basis. | |



ATTACH PAGES 3 AND 4 IF NOT USED

| 1. Kind of property or asset | 2. Disposition date Mr. Day Year | 3. Date sold Mr. Day Year | 4. Gross sales price (corrected price) | 5. Cost or other basis | 6. Expenses of sale and cost of im- provements made prior to disposition or March 1, 1953 | 7. Depreciation allowed (or allowable) since last depreci- ation or March 1, 1953 (explain in Schedule D) | 8. Gain or loss (column 4 minus column 6 plus column 7 minus column 8) | Gain or loss to be taken into account | |
|---------------------------------|--|------------------------------|--|---------------------------|---|--|---|--|------------|
| | | | | | | | | 9. | 10. Amount |

SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 6 MONTHS

| | | | | | | | | |
|--|----|----|----|----|----|----|-----|----|
| | \$ | \$ | \$ | \$ | \$ | \$ | 100 | \$ |
| | | | | | | | 100 | |
| | | | | | | | 100 | |
| | | | | | | | 100 | |
| | | | | | | | | |

Total net short-term capital gain or loss (enter in line 1, column 3, of summary below).

LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 6 MONTHS

| | | | | | | | | |
|--|----|----|----|----|----|----|----|----|
| | \$ | \$ | \$ | \$ | \$ | \$ | 50 | \$ |
| | | | | | | | 50 | |
| | | | | | | | 50 | |
| | | | | | | | 50 | |
| | | | | | | | | |

Total net long-term capital gain or loss (enter in line 2, column 3, of summary below).

SUMMARY OF CAPITAL GAINS AND LOSSES

| 1. Classification | 2. Net short-term capital loss of preceding taxable year (not in excess of net income for such year), but only to extent of net short- term capital gains of current year | 3. Net gain or loss to be taken into account from column 10, above | | 4. Net gain or loss to be taken into account from partnerships and common trust funds | | 5. Total net gain or loss taken into account in columns 2, 3 and 4 of this summary | |
|--|---|---|----------|---|----------|--|----------|
| | | (a) Gain | (b) Loss | (a) Gain | (b) Loss | (a) Gain | (b) Loss |
| Net short-term capital gain or loss | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Net long-term capital gain or loss | \$ | \$ | \$ | \$ | \$ | \$ | \$ |

Net gain in column 5, lines 1 and 2. (Enter as item 8 (a), page 1).

Net loss in column 5, lines 1 and 2. (The amount to be entered as item 8 (a), page 1, is (1) this item or (2) net
income, computed without regard to capital gains or losses, or (3) \$1,000, whichever is smallest).**COMPUTATION OF ALTERNATIVE TAX**

only if you had an excess of net long-term capital gain over net short-term capital loss, and item 23, page 1, exceeds \$18,000

| | | | |
|--|----|---|----|
| Net income (item 19, page 1) | \$ | 10. Normal tax (6% of line 7)..... | \$ |
| Gross of net long-term capital gain over net short-term capital loss (line 2, column 5 (a), minus line 1, col- umn 5(b), of summary above) | \$ | 11. Surtax on line 6. (See Instruction 26)..... | \$ |
| Ordinary net income (line 1 minus line 2) | \$ | 12. Partial tax (line 10 plus line 11)..... | \$ |
| Personal exemption. (From Schedule D-1)..... | \$ | 13. 50% of line 2..... | \$ |
| Credit for dependents. (From Schedule D-2)..... | \$ | 14. Alternative tax (line 12 plus line 13)..... | \$ |
| Balance (minus net income)..... | \$ | 15. Total normal tax and surtax (item 29, page 1)..... | \$ |
| Item 5 (a), page 1..... | \$ | 16. Tax liability (line 14 or line 15, whichever is the lesser). (Enter as item 30, page 1)..... | \$ |
| Exempt from estate tax. (From Schedule E-1 or E-2)..... | \$ | | |
| Balance subject to normal tax..... | \$ | | |

Schedule G.—GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY OTHER THAN CAPITAL ASSETS
(See Instruction 8)

| 1. Kind of property | 2. Date required | 3. Gross sales price (corrected price) | 4. Cost or other basis | 5. Expenses of sale and cost of improvements added prior to disposition or March 1, 1953 | 6. Depreciation allowed (or allowable) since last depreciation or March 1, 1953 (explain in Schedule D) | 7. Gain or loss (column 3 minus column 4 and column 5 plus column 6) |
|---------------------|------------------|---|---------------------------|---|--|--|
| | | \$ | \$ | \$ | \$ | \$ |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

Total net gain (or loss) (enter as item 8 (b), page 1).

to the family, fiduciary, or business relationship to you, if any, or purchaser of any of the items on this page
any of such items were acquired by you other than by purchase, explain fully how acquired.

Schedule H.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION. (See Instruction 9)

(1) nature of business Fruit Canning and Packing; (2) number of places of business 2; (3) business name and address if different from name and address on page 1 Lebanon, Oregon and Yakima, Washington
receipts.

See Schedule

4,275,985.00

COST OF GOODS SOLD

(and where inventories are an income-producing factor)

Inventory at beginning of year

Merchandise bought for sale

Total and supplies See Att. 1Cost (Garnish below). See Sch. 112,247

Total of lines 2 to 6

Inventory at end of year

Total goods sold (line 7 minus line 6)

Net profit (line 1 minus line 9)

| | | |
|--|--|--|
| | | |
| | | |
| | | |
| | | |
| | | |

OTHER BUSINESS DEDUCTIONS

11. Salaries and wages not included as "Labor" (do not deduct compensation for yourself). \$ 12,542.42
12. Interest on business indebtedness. 28,803.18
13. Taxes on business and business property. See Schedule 20,646.98
14. Losses (explain below). 8,129.75
15. Bad debts arising from sales or services. 13,330.76
16. Depreciation, obsolescence, and depletion (explain in Schedule J).
17. Rent, repairs, and other expenses (itemize below or on separate sheet). See Schedule 170,135.05
18. Amortization of emergency facilities (attach statement).
19. Total of lines 11 to 18. \$ 253,587.24
20. Total of lines 9 and 19. 2,083,634.93
21. Net profit (or loss) (line 1 minus line 20) (enter as item 9, page 1) \$ 192,350.87

In production, manufacture, purchase, or sale of merchandise is an income-producing factor, inventories are required. Enter "C," or "C or M," on line 9 to indicate whether inventories are valued at cost, or cost or market, whichever is lower.

Estimation of deductions claimed in lines 6, 14, and 17. See Schedule

you at any time after October 3, 1942, and before the end of your taxable year have in your employ more than eight individuals? Yes
(Yea or Noy)

If answer to first question is "Yes," have you in this return taken a deduction for any amount of wages or salaries representing an increase or decrease in rate after 3, 1942? No If answer to second question is "Yes," attach a statement explaining all such increases or decreases. If any of

increases or decreases required the prior approval of the National War Labor Board or the Commissioner of Internal Revenue as stated in Instruction also a copy of the authorization for each of such increases or decreases.

Schedule I.—INCOME FROM PARTNERSHIPS, FIDUCIARIES, AND OTHER SOURCES

IN (OR LOSS) FROM PARTNERSHIPS, SYNDICATES, ETC. (SEE INSTRUCTION 10 (a)) (FURNISH NAMES AND ADDRESSES)

| | | | |
|--|--|--|--|
| | | | |
| | | | |

INCOME FROM FIDUCIARIES (FURNISH NAMES AND ADDRESSES)

| | | | |
|--|--|--|--|
| | | | |
| | | | |

INCOME FROM OTHER SOURCES (STATE NATURE)

| | | | |
|--|--|--|--|
| | | | |
| | | | |

Total amounts in Schedule I. (Enter as item 10, page 1)

Schedule J.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES K, L, C, AND XM B

| 1. Kind of property (e.g., office material of which constructed) | 2. Date acquired | 3. Cost or other basis (Do not include land or other nondepre- ciable property) | 4. Assets fully depre- ciated in use at end of year | 5. Depreciation al- lowed (or allowable) in prior years | 6. Remaining cost or other basis to be recovered | 7. Estimated life used in accumulating depre- ciation | 8. Estimated remaining life from beginning of year | 9. Depreciation allowable this year |
|--|---------------------|--|---|---|--|---|--|---|
| Bldgs. | 1937 | \$ 3,500.00 | | \$ 1011.11 | \$ 2488.89 | 15 yr. | | \$ 233.33 |
| Equip. | 1941-2 | 2,418.41 | | 120.00 | 2298.41 | 10 yr. | | 241.84 |
| Other Equip. | 1942 | 2,000.00 | | | 2000.00 | 5 yr. | | 11.33 |
| | | | | | | | | 508.50 |



C. B. SPENCER

NET OPERATING LOSS CARRY-BACK

2-28-45 to 2-28-43

| | |
|---------------------------------------|--------------|
| Gross Receipts (3-1-44; 2-28-45)..... | \$ 33,562.28 |
|---------------------------------------|--------------|

Business Deductions:

| | |
|---|--------------|
| Taxes on Real Estate in business..... | \$ 1,951.01 |
| Interest on Loans..... | 3,546.39 |
| Bad Debt arising from Sales & Services | 107,567.51 |
| Depreciation | 35,829.37 |
| Legal Audit and Insurance..... | 10,954.74 |
| Moving Expense | 765.61 |
| | <hr/> |
| Net Operating Loss..... | (127,052.35) |

| | |
|---------------------------------------|-----------|
| Gain from sale of capital assets..... | 17,141.39 |
|---------------------------------------|-----------|

| | |
|---|-----------------|
| Net Carry-back Loss from 2- 28-45 to fiscal year ending 2-28-43, as defined by Section 122 IRC | \$ (109,910.96) |
| | <hr/> |

1943 Fiscal—Tax Re-computation

| | |
|--|---------------|
| Net Income per Amended Return (See Return attached) | \$ 191,172.19 |
| Less Net Operating Loss Deduction above | 109,910.96 |
| | <hr/> |
| Net Income | 81,261.23 |
| Less Personal Exemption..... \$ 1,200.00 | |
| Credit for Dependents | 700.00 |
| | <hr/> |
| Surtax Net Income | 79,361.23 |
| Less Earned Income Credit..... | 1,400.00 |
| | <hr/> |
| Normal Tax Net Income..... | \$ 77,961.23 |
| Normal Tax (on \$77,961.23)..... | \$ 4,677.67 |
| Surtax (on \$79,361.23)..... | 43,480.09 |
| | <hr/> |
| Tax for 1942 | \$ 48,157.76 |
| Paid on Amended Return..... | \$ 141,722.80 |
| Tax above | 48,157.76 |
| | <hr/> |
| Net Refund due..... | \$ 93,565.04 |

STATEMENT OF CASE

Claimant filed Individual Income Tax Returns for the years, amounts and taxes, as follows:

| Fiscal Year ending February 28th | Net Income | Tax Liability |
|----------------------------------|--------------|---------------|
| 1943 (Amended Return)..... | \$191,172.19 | \$141,722.80 |
| 1944 | 72,272.84 | 43,588.18 |

By reason of the forgiveness feature of the Revenue Act of 1943, the claimant paid \$76,107.40 on his 1942 income, \$76,297.91 on his Declaration of Estimated Tax on 1943 income, and \$214.53 on his Individual Income Tax Return for the fiscal year ended February 29th, 1944.

Claimant filed an Estimate Form 1040-ES for the fiscal year ended February 28, 1945, showing no tax due. Subsequently, and on or about April 20th, 1945, claimant filed his Income Tax Return, which showed a net loss of \$118,481.66, of which \$109,910.96 represents a net operating loss carryback as defined by Section 122, Internal Revenue Code.

As a part of claimant's estimate on Form 1040-ES, for the fiscal year February 28, 1945, is the following statement:

"My principal business is conducted under the name of the 'Spencer Packing Company.' This company is operating under leases which provide for payment upon the basis of the number of cases of fruits and vegetables processed and packed. At this time, it is impossible to anticipate what the year's pack will amount to and, consequently, it is also impossible to de-

termine whether any profit at all will result from the operations. It does not now appear that there will be any net profit for the year or that there will be any tax to be paid for the year.

“My fiscal year ends February 28th.”

This statement, signed by both C. B. Spencer and Grace N. Spencer, was filed about August 3rd, 1944.

Claimant has been engaged in the food packing and processing business in various capacities throughout his entire business life, and, independently on his own behalf, since 1935. During the year 1935, claimant purchased a warehouse in the City of Lebanon, Oregon, and equipped it for canning prunes, and, in the beginning of his operation, packed this fruit for the growers upon a cost-plus basis. During the year 1936, claimant added other equipment and in addition to canning prunes, cold-packed and canned cherries, tomatoes, pumpkin, gooseberries, strawberries, raspberries, loganberries, blackberries, and also continued packing prunes as formerly, upon a cost-plus basis.

During the period from 1936 to 1940, inclusive, claimant packed all of the fruits and vegetables listed in the next preceding paragraph, the operation for this period being entirely upon a cost-plus basis. Also, during this period, as profits were made and as additional moneys were procured, additional machinery and buildings were added to the

Lebanon plant, until it had been completed and equipped as a well integrated vegetable, fruit and food packing and processing plant.

On July 24, 1940, claimant leased the food cannery and processing plant of Yakima Growers Co-Op. At that time, this organization was defunct and was not operating. During this first year, claimant packed the products of the members of the Co-Op for the right and privilege of using the plant and the equipment, and in addition to packing their products, paid the Co-Op 5c per case on all other food products packed on his own behalf.

During the years, 1941, 1942 and 1943, claimant continued the operation of both the Lebanon and Yakima plants upon the same basis as prior years, except that at Yakima the growers were paid cash for their products, together with 5c per case for the use of their portion of the plant. In the meantime, claimant had constructed a building of his own and had purchased and added to that plant additional machinery [12] and equipment which he had acquired on his own behalf. In addition to modernizing both plants, the capacity was further increased and expanded.

During the year 1943, at the urgent request of the War Food Administration, claimant purchased an unused and illly equipped dehydration plant at Lebanon and reconstructed and rebuilt said plant so as to develop it into a first-class food dehydrating operation. Also, during the period after December, 1941, the additions made to the plants at Yakima and Lebanon were made upon the basis of

urgent requests of the Government Agencies to increase the pack for lend-lease and Military use.

Also, during the year 1943 with the addition of the plants, the increasing difficulties in getting raw products, materials and supplies, financing, and sufficient personnel, and the further fact that under the strain and pressure of the increased operation, claimant's health was beginning to break, it became obvious that it would be necessary to reorganize and revise the operations. In furtherance of this plan, it was considered proper and expedient to organize operating corporations for each of the plants. Furthermore, the financing of the Washington plant was done by Washington financial institutions, and the Oregon plants were financed by Oregon financial institutions. It was becoming increasingly difficult to complete the financing of these interstate plants without a segregation of the operations so that the obligations of each individual unit could be governed by such limitations and restrictions as were applicable to such separate, individual units. In furtherance of this plan, claimant leased his respective plants to the newly organized corporate operating units upon a per case basis in accordance with the custom of the trade. In addition, however, to the mere leasing of the plants to the corporate operations, claimant furnished as an additional service for the charge made, complete management and guaranteed the operating units adequate financing. While claimant was an officer of each of the corporations, he drew no compensation as such for the services rendered except the

per case charge, which constituted [13] the entire compensation be received for the three distinct services furnished, to-wit: the plants, management and finances.

The leases to the various plants were first drafted for a period of three years commencing March 1st, 1943, with the option of renewal. These leases were delivered to the financing organizations and in addition, were recorded with the County Clerks of Linn County, Oregon, and Yakima County, Washington. These leases contained the following paragraph:

“5. Financing: It is recognized that large sums of money will be required to finance the operations of Lessee, and Lessors hereby agree that when required they will provide (through personal guarantee and through the pledge of such of their property covered by this Lease as may be necessary) adequate financing for the needs of Lessee, as a part of the services to be performed in consideration of the rental to be paid hereunder.”

For many years, claimant's Lebanon operations had been financed through the United States National Bank of Portland (Oregon), and the Yakima operations had been financed through the Seattle First National, Yakima Branch. On October 5, 1943, the Spencer Packing Companies of Yakima and Lebanon, and C. B. Spencer (pursuant to the foregoing Lease Agreement) entered into a financing arrangement with the American Business Credit Corporation, of Portland, Oregon. As

guarantor and endorser, said C. B. Spencer became personally liable on the financing contract. Similar agreements were entered into by C. B. Spencer and the Spencer Dehydrators, Inc., and on the strength of each of these arrangements, said American Business Credit Corporation opened lines of credit.

Due to the excessively high Federal Taxes which claimant was required to pay for the fiscal years ended February 28, 1943, and February 29, 1944, and the rapid expansion of the plants to meet the requests of the Federal Agencies, and due to claimant's inability to procure sufficient personnel and adequate financing to purchase enough raw products to operate profitably (coupled with certain unfortunate experiences in fruit and vegetable losses), claimant was compelled to dispose of [14] the Yakima plant during the year 1944, and to discontinue his operations at that point.

Also due to the exactions of the Food Administration with respect to the products dehydrated at the dehydration plant in Lebanon, Oregon, that company sustained staggering losses during each year of its operations. Furthermore, the Food Administration refused to supply the dehydration operation with further orders, and on November 30, 1944, Mr. W. J. Chastain of the Food Administration, recommended to the claimant that the dehydration plant be closed. These unfortunate circumstances so increased claimant's loss that it was also necessary during the fiscal year ended February 28, 1945, to abandon the dehydration operations and to close that plant.

During the fiscal year ended February 28, 1945, the Spencer Dehydrators, Inc., and the Spencer Packing Company of Yakima were liquidated with bad debt losses as follows, which resulted from amounts owing to claimant on account of unpaid rentals, advances and amount paid on guaranty:

| | |
|------------------------------------|-------------|
| Spencer Dehydrators, Inc..... | \$73,601.49 |
| Spencer Packing Co. of Yakima..... | \$33,966.02 |

Claimant had no source of income other than from his business of property rentals, food processing plant operation and financing of three corporations engaged solely in this work. As part of the rental agreement, the claimant pledged his assets and credit in order to finance the corporations. It constituted a step or steps in the principal business and trade, and one to which claimant regularly devoted all his time exclusively. Claimant received no salaries as officer of the three corporations, and neither did he receive dividends. He made numerous trips between his Lebanon and Yakima cannery corporations to supervise operations, arrange for financing, and keep a close check on the operations (which necessarily [15] tied up his personal fortunes as well). One of the corporations recognized a gain for the year's operations, but the other two, on liquidation, showed a substantial loss. The results of the previous years' operations warranted the claimant in believing that he would realize substantial profits in this year also.

Argument

This Claim is filed under the provisions of Section 122 of the Internal Revenue Code, which provides in part, as follows:

“(a) Definition of Net Operating Loss.—As used in this section, the term ‘net operating loss’ means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) Amount of Carry-Back and Carry-Over.—

(1) Net operating loss carry-back.—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(c) Amount of Net Operating Loss Deduction.—The amount of the net operating loss deduction shall be the aggregate of the net

operating loss carry-overs and the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (computed without such deduction and without the credit provided in section 26 (e));

(d) Exceptions, Additions, and Limitations.—The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

* * *

(4) Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section [16] 117 (b). As so computed the amount deductible on account of such losses shall not exceed the amount includable on account of such gains."

In arriving at the "net operating loss" which may be carried back, the additions and limitations which are material to the loss herein claimed are subsection (d) (4) relating to capital gains.

This provision of the statute had its origin in the Revenue Act of 1918, Section 204 (a), which provided in part as follows:

"That as used in this section the term 'net loss' refers only to net losses resulting from

either (1) the operation of any business regularly carried on by the taxpayer, * * *

In the Revenue Act of 1921, the phrase "any business" was expanded to read "any trade or business." In *Hughes v. Commissioner*, 38 Fed. 759, 8 AFTR 10385 (CCA-10th, 1930), the Circuit Court of Appeals in discussing this section, said:

"This section (Sec. 204 (a)), in somewhat different language, was first enacted in 1918. The mischief it was aimed at is a matter of common knowledge. Merchants and manufacturers, and other taxpayers employing capital in their pursuits, had paid large taxes in preceding years on paper profits. Their shelves and warehouses bulged with inventories whose values had increased fabulously during the inflation period. The war had ended; deflation was forecast; war trade was at an end.

"A class of taxpayers had paid taxes on incomes reflected by inventories, an income not in fact realized. There was no one to recoup them the losses caused by the shrink in the value of their assets. This action was designed to permit such taxpayers to carry over such losses into the two succeeding years. (In the report of the 1918 law to the Senate, the Committee, speaking of this section, said:) * * *

(Omitted, not particularly relevant.)

Montgomery, in his work on Income Tax Procedure (1922 Ed.) at page 1021, says of this section:

"The radical changes expected in business conditions as a result of the cessation of the

war made it seem imperative that losses arising from readjustments of inventories, which might occur within a few months thereafter should be spaced over a longer period of time. Similar conditions existed in case of losses arising from sales or depreciation of plant and equipment acquired for war purposes. To meet those difficulties the 1918 law provided certain relief measures designed to assist in the reestablishment of normal conditions.'

"* * * Considering the manifest intention of Congress to restrict the application of the section, and the evident purpose of the law, it is our opinion that the section has no application to wage-earners, salaried or professional men. Wage-earners and salaried men may be out of work and subject to no tax. But, employing no capital in their 'trade or business regularly carried on,' they suffer no net losses that should be carried over to other years. * * *"

In that case the petitioner, a lawyer, sustained a loss in investment banking in 1921 which he sought to carry forward to 1922. The Court held that this lawyer's business included investment banking and allowed the net loss carry-over since he spent about 20% of his time in that endeavor. By the stronger reason the contention of claimant should be allowed as he spent 100% of his time in carrying on the business involved in this claim.

Revenue statutes are to be construed strictly, and doubts in its terms are to be resolved against the Government and in favor of the taxpayer. This

rule was set forth in U. S. v. Merriam, 263 U. S. 179, 44 Sup. Ct. 69, 4 AFTR 3673 (1923), as follows:

“* * * But in statutes levying taxes the literal meaning of the words employed is most important for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the government and in favor of the taxpayer. Gould v. Gould, 245 U. S. 151, 153, 38 Sup. Ct. 53, 62 L. Ed. 211. The rule is stated by Lord Cairns in Partington v. Attorney General, L. R. 4 H. L. 100, 122:

‘I am not at all sure that in a case of this kind—a fiscal case—form is not amply sufficient; because, as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.’”

This rule is applicable particularly to the net loss carry-over and carry-back [18] provisions of the statute, for in Burnet, Comr. v. Marston, 57 F. (2d) 611, 10 AFTR 1586 (CA of DC, 1932) the Court of Appeals stated:

“Section 204, being a relief measure, should be construed liberally in favor of the taxpayers to give the relief it was intended to provide.”
* * * (Cases cited)” (These cases deal with other sections, and are not any improvement on the present case.)

In that case, petitioner was a member of a partnership engaged in investment banking. In 1920 the partnership was dissolved, and liquidation commenced. In 1922 petitioner made payments aggregating \$725,000 on account of losses sustained by the firm. His gross income was \$633,000, leaving a net business loss for 1922 of \$92,000. Commissioner refused to allow any part of this net loss for 1922 as a deduction against the taxpayer's income for 1923. The Board of Tax Appeals held for petitioner. On appeal, the Board was affirmed. Commissioner contended that petitioner had not been engaged in the investment banking business during 1922, and therefore that the loss was not sustained in “any trade or business.” Held, that the phrase “during the taxable year” was an interpolation by the Commissioner and does not appear in the statute. Regulation in conflict with the terms of the statute will not be sustained.

In determining the net operating loss for the fiscal year ended February 28, 1945, two deductions as follows are included:

| | |
|----------------------------------|-------------|
| Bad debt of Spencer Dehydrators, | |
| Inc. | \$73,601.49 |
| Bad debt of Spencer Packing | |
| Company of Yakima..... | \$33,966.02 |

In accordance with the provisions of Section 122 (d)(5), Internal Revenue Code, in order for these two items to be allowable deductions in determining the net operating loss, it must appear that they are attributable to the operation of a trade or business regularly carried on by the taxpayer. That they were incurred in such a business is evident from the facts and from the law as enunciated in the following cases: [19]

In an early case, *Flint v. Stone Tracy Co.*, 220 U. S. 107, 3 AFTR 2834 (1911), our Supreme Court, in defining "business" for the purposes of the Corporation Excise Tax of 1909, said:

"‘Business’ is a very comprehensive term and embraces everything about which a person can be employed. Black’s Law Dict. 158, citing *People ex rel. Hoty v. Tax Comrs.* 23 N. Y. 242, 244. ‘That which occupies the time, attention, and labor of men for the purpose of a livelihood or profit.’ 1 *Bouvier’s Law Dict.* p. 273.

“We think it is clear that corporations organized for the purpose of doing business, and actually engaged in such activities as leasing property, collecting rents, managing office buildings,

making investments of profits, or leasing ore lands and collecting royalties, managing wharves, dividing profits, and in some cases investing the surplus, are engaged in business within the meaning of this statute, and in the capacity necessary to make such organization subject to the law.”

While this case involved the activities of a corporation, there are no sound reasons for applying a contrary rule to individual taxpayers.

Under the net loss carry-over provisions of the Revenue Act of 1921, the Board discussed the facts of Oscar K. Eyserbach, 10 B.T.A. 716, as follows:

“For several years prior to 1923, petitioner was engaged in the business of purchasing and developing mineral leases. The majority of these leases were oil and gas leases. In this line of business, petitioner prior to and in 1921 purchased interests in the lead and zinc leases referred to in the findings of fact and proceeded to develop one of these properties. This effort failed in 1921, after petitioner had expended \$30,000. The question presented is, was this loss a ‘net loss’ as that term is defined in section 204 of the Revenue Act of 1921? The pertinent parts of that section read: * * *

“It is to be noted that in order to constitute a ‘net loss,’ it is not necessary that taxpayer should sustain the loss in his principal business or vocation. The word ‘business’ is qualified by the word ‘any.’ The taxpayer is entitled to this

benefit where the loss is incurred in 'any trade or business regularly carried on' by him. That petitioner's activities in oil, gas, zinc and lead constitute a business seems clear. They fall within the definition of 'business' given in *Flint v. Stone Tracy*, * * *.

"That petitioner 'regularly carried on' the business of purchasing and developing zinc and lead leases is equally clear. It was not an isolated enterprise. His zinc and lead operations dovetailed with his other [20] mine operations. On this point petitioner is sustained."

The Board stressed "activity" and "regularity."

In the case at bar, the claimant since 1935 and 1942-43 has been the owner of the premises occupied during 1944 by the three canneries. He was in active control of the operations. These activities consisted of the ownership, leasing and management of the cannery properties, and the financing of the canneries. Claimant began this arrangement about March 1, 1943, and it continued throughout the balance of 1943, all of 1944, and part of 1945. Over his signature a line of credit was opened up to the three cannery corporations. This guaranty by the claimant was in accordance with the terms of the Lease and was part of the consideration whereby the corporations paid rental and had the use of the land and buildings and machinery. The Lessor and Lessee in each instance had carried on this arrangement for a year preceding the year in question. It required claimant's constant care and attention and

permitted him no other activity. It was not his avocation, but rather his full-time vocation. He acted not for any corporation, but in his own self-interest. And while so acting, he incurred the two bad debt losses mentioned hereinabove.

Obviously, if the taxpayer for his whole business career had engaged in the business of renting property and financing the tenants, there would be such continuity of business as to stamp it as a "trade or business regularly carried on by the taxpayer." Such was the situation in Glenn M. Averill, 20 B.T.A. 1196 (appeal dismissed 53 F. (2d) 1079 (CCA-8th, 1931)), which led the Board to say:

"* * * When an activity ceases to be isolated and assumes a continuity and importance that characterize it as an activity regularly engaged in, must necessarily depend on the facts of each particular case. Obviously, in every case a business to be regularly carried on must be characterized by a continuing activity in some field of business endeavor. The loss contemplated by the statute is an operating loss, and the party claiming it must be the operator of the trade or business in which the loss occurs. Therefore, a business regularly carried on by the taxpayer means a business regularly operated by the taxpayer on his own behalf."

In Charles M. Bryan, 21 B.T.A. 364, the petitioner took over the management of a truck business early in 1922. His principal business or occupation up to that time had been the practice of law, and

during 1922 he spent two hours each in the forenoon and afternoon at the truck company's office, as well as returning every evening. He still practiced law. The Board pointed out that the loss was not limited to those sustained in the principal or sole trade or business.

“* * * The text is the ‘regularity’ with which a trade or business is carried on. * * *

“* * * We think, on the whole, that petitioner was regularly engaged in the business during 1922, within the intendment of the pertinent statute, and that the loss he sustained * * * was a ‘net loss’ which may properly be applied against his net income for the year 1923.”

In that case the petitioner had engaged in the business only for 1922, one year, yet the net loss carry-over was allowed. In the case at bar the taxpayer has engaged in this particular type of business of operating food processing plants for cannery purposes for many years. The test, then, is not the number of years of carrying on the business, but rather the regularity within the loss year with which the taxpayer has engaged in the enterprise. Otherwise the Bryan decision is inexplicable.

Neither is the time spent each day in the prosecution of the endeavor the test. The Board said in *S. Rose Lloyd*, 32 B.T.A. 887, at 891:

“* * * It is not necessary that one occupy a full day each day in carrying on one’s activity to be considered to be regularly engaged in

business. It is continuity of efforts devoted to the undertaking which constitutes a business regularly carried on.* * *” (Cases cited.)

In that case the taxpayer managed and traded and sold the inheritance from her father. It was her sole source of income, and she had the office in her home. She carried on a voluminous correspondence, and personally she negotiated the sales. The Board held that she was engaged in the business of buying and selling real estate. [22]

In the case at bar, the claimant has habitually and continually spent a full day each day in carrying on his business of renting the properties, operating them, and keeping a check on the financial arrangements. Much of the time he is traveling between his Lebanon and Yakima properties. He has no other source of income or profit.

Such a schedule, multiplied by virtually every working day of the year, is susceptible of only one characterization,—“continuous effort.”

As stated hereinabove, the claimant rendered three distinct services to the corporation,—plant rental, operation and financing. His activities revolved around these. In the course of such activities, it became necessary to close down the Yakima operations and thereby lose the amounts owing to claimant.

Closely in point is the case of T. I. Crane, 17 B.T.A. 720. The Petitioner for many years had been a member of a partnership engaged in selling coal and iron on commission and the promotion and

financing of corporations. In 1916, the partnership was dissolved, but the Petitioner continued as an individual the business of financing. He made many loans, and had a staff of three who handled his affairs. He was President of one corporation and an officer of another, from each of which he got a salary. He spent one-half day each week on the companies' affairs, and the rest of the time was spent on his loans, etc. Several corporations in which the Petitioner held substantial amounts of stock failed, and the Petitioner sustained (1) losses on the sale of the stock, and (2) losses on the loans. In deciding whether these losses were incurred in a "business" so as to be used in computing a net loss under Section 204 to be carried over to 1922, the Board said:

"* * * We have held that it is not necessary that the loss result solely from the carrying on of a taxpayer's principal business, but it is sufficient if the loss results from the operation of any business if that business be one regularly carried on by the taxpayer. * * * [23]

"Respondent's position is that petitioner's sole business for the year 1921 was that of a salaried executive officer of various corporations. In reaching such a conclusion we think respondent failed to give sufficient consideration to petitioner's other activities.

"The evidence satisfies us that petitioner was engaged in the business of financing mining and related corporations, and such financing involved through investigation as a preliminary,

and regular supervision subsequent to the advancing of the money. This work took up all of his time with the exception of about one-half day a week, which was spent performing his duties as a salaried officer of two corporations. Petitioner derived profits from his business in two ways: first, the receipt of interest upon his loans, and second, the receipt of dividends upon and profits from the sale of capital stock. His losses resulted from the failure of debtor corporations to repay loans and from the sale of stock at a loss.

"From the foregoing it appears that during the year 1921 petitioner's business was not only that of a corporate executive officer, as conceded by respondent, but he regularly carried on the business of financing mining and related corporations, which financing sometimes took the form of loans and at other times the acquisition of stock in the company, the method followed being determined by the circumstances."

And, again in Royal W. Irwin, 37 B.T.A. 51, which was acquiesced in by the Commissioner, the petitioner, a lawyer, invested in mining property over a period of years, and realized a loss in 1931 when his option was terminated. He carried about half his loss forward into 1932, which was denied by the respondent. The Board, in holding for the petitioner, said:

"* * * The evidence shows, however, that the petitioner was regularly engaged in the min-

ing business in connection with this particular property during all of the period from 1922 until the termination of the agreement in 1931. He gave the work a part of his personal attention, made frequent visits to the property, received regular reports from his mining engineer, wrote frequently to the latter instructing him in the conduct of the work, and was personally responsible for all decisions. He was also engaged in other business and he failed to develop this property commercially, but those facts did not prevent him from being regularly engaged in this mining business." (Cases cited)

The fact that the claimant has devoted all his efforts into corporations in which he was financially interested, does not weaken his case at all. In **Edwin H. Conrades**, 21 B.T.A. 213, the Board said in part:

"The fact that petitioner limited the field of his loans to corporations directed by him and individual associates with whose affairs and financial standing he was familiar, does not alter the fact that in making these loans he was carrying on a personal business distinct from the business carried on by the corporations in question. There is nothing in our opinion peculiar or significant in such limitations. * * * The fact that in making many of these loans he was, in addition to obtaining interest, safeguarding his investments by providing the funds needed by his various corporations, does

not, in our opinion, stamp the loan activities as merely an incident of his service as an officer of these various corporations or as merely incidental to his ownership of corporate stock. * * *

See also Washburn v. Commissioner, 51 F. (2d) 949, 10 AFTR 343 (CCA-8, 1931), reversing 16 B.T.A. 1091.

The direct result of claimant's efforts during the fiscal year ending February 28, 1945, was the loss claimed herein. Based upon the facts and the law, it is submitted that such loss was an "net operating loss" within the provisions of Section 122 of the Internal Revenue Code. It follows that this claim for refund should be allowed. [25]

[Affidavit of service by mail attached.]

[Endorsed]: Filed November 9, 1945. [26]

[Title of District Court and Cause.]

PETITION FOR EXTENSION OF TIME

Comes Now Carl C. Donaugh, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, and based on the affidavit attached hereto, which is by this reference made a part and parcel of this petition, moves the Court for an order for a 30-day extension of time within which to answer or otherwise plead in the above-entitled cause. The extension of time is requested upon the ground and for

the reason that the Internal Revenue Department has not complied with the request of the Attorney General of the United States by sending the files of the within cause to the said Attorney General and until said files are received we have no information upon which to prepare an answer or otherwise plead herein.

Dated at Portland, Oregon, this 29th day of December, 1945.

CARL C. DONAUGH,
United States Attorney for
the District of Oregon.

/s/ VICTOR E. HARR,
Assistant United States
Attorney. [27]

United States of America,
District of Oregon—ss.

I, Victor E. Harr, being first duly sworn, upon oath depose and say: That I am Assistant United States Attorney for the District of Oregon; that on December 21, 1945, the office of the United States Attorney received a telegram from the Attorney General's office, Washington, D. C., advising that the files in the above-entitled cause had not as yet been received from the Department of Internal Revenue; that until said files are received from the Attorney General we are not prepared to file an answer to the within cause or to otherwise plead;

that this affidavit is made in support of a petition for an extension of time within which to answer or to otherwise plead.

Dated at Portland, Oregon, this 29th day of December, 1945.

/s/ VICTOR E. HARR.

Subscribed and sworn to before me this 29th day of December, 1945.

/s/ L. JEANETTE BEAR,
Notary Public for Oregon.

My commission expires: 9-23-47.

[Endorsed]: Filed December 29, 1945. [28]

[Title of District Court and Cause.]

**AFFIDAVIT IN OPPOSITION TO PETITION
FOR EXTENSION OF TIME**

State of Oregon,
County of Multnomah—ss.

I, Robt. T. Jacob, being first duly sworn, depose and say: That I am one of counsel for Plaintiff in the above-entitled cause and have been counsel for a period of several years, and have full knowledge of the financial position of the Plaintiff; that the claim for refund in this case arises from a heavy operating loss by Plaintiff suffered during his fiscal year 1944 in the sum in excess of \$127,000.00; that at the time of the occurrence of the loss the Plaintiff was already very heavily in debt because of large sums of money which he had borrowed from the American Business Credit Corporation for the purpose of making payment of his

1942 income tax; that said Plaintiff is still under very heavy financial pressure in that he has not been able to liquidate his loans from American Business Credit Corporation to whom he is indebted in the approximate sum of \$50,000.00; that, in addition, said Plaintiff is indebted for many other notes and accounts payable which he is currently unable to pay.

That since the filing for claim for refund in this case, the Bureau of Internal Revenue has not made any investigation of said claim to the knowledge of affiant, and has not contacted either affiant or Plaintiff concerning said claim; that a period of more than eight (8) months has expired since the filing of the claim for refund; that this delay has worked great hardship upon the Plaintiff.

Dated at Portland, Oregon, this 5th day of January, 1946.

/s/ ROBT. T. JACOB.

Subscribed and sworn to before me this 5th day of January, 1946.

[Seal] /s/ DOROTHY ORR,

Notary Public for Oregon.

My Commission Expires: 10-23-49.

[Endorsed]: Filed January 5, 1946. [29]

Service acknowledged of the foregoing Affidavit in Opposition to Petition of Extension of Time.

/s/ VICTOR E. HARR,
Signature.

Dated: 1/5/46. [30]

[Title of District Court and Cause.]

ANSWER

The complaint is answered (by paragraphs corresponding to the paragraphs of the complaint) as follows:

1.

Admitted.

2.

Admitted.

3.

Denied, except admitted that the amount in controversy exceeds \$3,000. It is averred that no claim for refund, sufficient to give this Court jurisdiction, was filed as required by law.

4.

Denied, except admitted that plaintiff filed on or about June 15, 1944, an amended individual income tax return for the fiscal year ending February 28, 1943, evidencing a total tax liability of \$141,722.80; admitted that plaintiff filed on or about June 14, 1944, an individual income and victory tax return for the fiscal year ending February 28, 1944, evidencing a total income and victory tax liability of \$43,588.18; admitted or averred that plaintiff paid to the Collector of Internal Revenue \$76,297.91 on or about October 8, 1943, \$1,394.59 on or about

October 8, 1943, \$76,297.91 on or about February 19, 1944, and \$214.53 on or about March 22, 1945.

5.

Denied.

6.

Denied, except admitted that plaintiff filed with the Collector of [31] Internal Revenue for the District of Oregon, on or about April 21, 1945, an instrument purporting to be a claim for refund in the amount of \$93,565.04 for the fiscal year ending February 28, 1943, and admitted that Exhibit A of the complaint is a true copy of the instrument filed.

7.

Denied, except admitted that more than six months elapsed from the filing of the alleged claim for refund and the filing of the complaint.

As a Further Defense It Is averred That:

1.

The alleged claim or instrument purporting to be a claim for refund concerned, and is stated therein to apply to, plaintiff's fiscal year 1943.

2.

That under the provisions of the Current Tax Payment Act of 1943, more particularly Section 6 thereof, the income taxes allegedly overpaid and sought to be recovered by plaintiff in this action

are made applicable to and concerned plaintiff's fiscal year 1944, and not the fiscal year for which the alleged claim for refund was filed. It is further averred that plaintiff is not entitled to recover since there was no overpayment of income taxes for the fiscal year 1943, or for the fiscal year 1944.

3.

That this Court has no jurisdiction in that no adequate or sufficient claim for refund was filed as required by law.

Wherefor having fully answered, defendant prays judgment dismissing plaintiff's complaint and for costs.

HENRY L. HESS,
United States Attorney.

/s/ VICTOR E. HARR,
Assistant United States
Attorney.

/s/ THOMAS R. WINTER,
Special Assistant, United
States Attorney.

Copy received Jan. 28/46. Jerome S. Bischoff.

[Endorsed]: Filed January 28, 1946. [32]

[Title of District Court and Cause.]

MOTION FOR PRELIMINARY HEARING
AS TO JURISDICTIONAL DEFENSE

Comes now the Plaintiff above named and through Jerome S. Bischoff, one of his counsel, and moves the Court for an order under the provisions of Rule 12 (d) setting a time for a preliminary hearing before trial as to the merits of the alleged jurisdictional defense contained in Defendants "further defense" on the ground that said defense alleges this Court has no jurisdiction of the within action for failure of Plaintiff to file a sufficient claim for income tax refund as required by law.

Plaintiff requests that a hearing be held on Monday, February 18th, or such time thereafter as may suit the convenience of the Court.

/s/ JEROME S. BISCHOFF,
Counsel for Plaintiff.

Service accepted this 4th day of February, 1946.

/s/ VICTOR E. HARR,
Asst. U. S. Atty.

[Endorsed]: Filed February 5, 1946. [33]

[Title of District Court and Cause.]

PRE-TRIAL ORDER

The above-entitled action came on regularly for pre-trial conference before the Honorable James Alger Fee, one of the Judges of the above-entitled Court. Plaintiff appeared by and through Robert T. Jacob and Jerome S. Bischoff, his attorneys; defendant appeared by and through Henry L. Hess, United States Attorney, Victor E. Harr, Assistant United States Attorney, and Thomas R. Winter, Special Assistant to the United States Attorney.

Agreed Facts

I.

C. B. Spencer, plaintiff, is a citizen of the United States, residing in the State of Oregon, and during all times herein concerned, defendant was, and now is, the duly appointed, qualified and acting Collector of Internal Revenue for the District of Oregon.

II.

The amount in controversy exceeds the sum of \$3,000.00

III.

On or about June 15, 1944, plaintiff filed an amended individual income tax return for the fiscal year ending February 28, 1943, evidencing a total tax liability of \$141,722.80; that on or about June 15, 1944, plaintiff filed an individual income and victory tax return for the fiscal year ending February 28, 1944, evidencing a total income and victory tax lia-

bility of \$43,588.18; that the plaintiff paid to the defendant, Collector of Internal Revenue for the District of Oregon, \$76,297.91 on or about October 8, 1943; \$1,394.59 on or about October 8, 1943; \$76,-297.91 on or about February 19, 1944, and \$214.53 on or about March 22, 1945. [34]

IV.

That on or about April 21, 1945, the plaintiff filed with the defendant, Collector of Internal Revenue for the District of Oregon, an instrument purporting to be a claim for refund in the amount of \$93,565.04. Said instrument is attached to the complaint as Exhibit "A" and is a true copy of the instrument filed.

V.

More than six months elapsed from the filing of said instrument to the date of filing of the present action and no notice of allowance or disallowance was received by the plaintiff during such period.

Contention of the Parties

Defendant contends that the alleged claim or instrument purporting to be a claim for refund concerned, and is stated therein to apply to, plaintiff's fiscal year 1943; that under the provisions of the Current Tax Payment Act of 1943, more particularly Section 6 thereof, the income taxes allegedly overpaid and sought to be recovered by plaintiff in this action are made applicable to and concerned plaintiff's fiscal year 1944, and not the fiscal year for which the alleged claim for refund was filed.

That for the above reasons this Court has no jurisdiction in that no adequate or sufficient claim for refund was filed, as required by Section 3772 of the Internal Revenue Code (Title 26 U. S. C. A.).

Plaintiff's position is that the carryback refund is applied to the income tax paid for the second taxable year preceding the loss; that is, the tax paid on account of income earned during the year March 1, 1942, to February 28, 1943, and accruing in that year. Plaintiff claims that the answer to Question 2 on Form 843 correctly states the taxable "period" for year and, secondly, that even if the face sheet is ambiguous or in error in the designation of the "period," that the body of the claim fully sets out all pertinent facts sufficient to enable the Commissioner to make an accurate determination of the nature of the claim, the taxable period involved, dates of payments, and any and every other element necessary to enable him to make a determination.

Issues of Fact to Be Determined

I.

There are no issues of fact to be determined on the question of the [35] merits of the alleged jurisdictional defense.

Issues of Law to Be Determined

Whether the alleged claim or instrument purporting to be a claim for refund is an adequate or sufficient claim for refund, as required by Section 3772 of the Internal Revenue Code and the regulations established in pursuance thereof.

Pretrial Exhibits

I. Refund Claim and Exhibits contained therein.
(Attached to Complaint.)

II. Individual Income and Victory Tax Return,
C. B. Spencer, for year ending 2/29/44.

The foregoing pretrial order relates solely to the question of jurisdiction. The order shall not be amended unless by consent of the parties or to prevent manifest injustice. When the issue of jurisdiction has been determined the court may proceed to the settlement of another pretrial order relating to other issues.

Dated at Portland, Oregon, this 4th day of March,
1946.

JAMES ALGER FEE,
United States District Judge.

Approved:

/s/ HENRY L. HESS,
United States Attorney.

/s/ VICTOR E. HARR,
Assistant United States
Attorney.

/s/ THOMAS R. WINTER,
Special Assistant to the
United States Attorney.

/s/ JEROME S. BISCHOFF,
Attorneys for Plaintiff.

[Endorsed]: Filed March 4, 1946. [36]

[Title of District Court and Cause.]

NOTICE

To: The Clerk of the Above Entitled Court

Will you kindly enter the name of Randall S. Jones as an associate counsel of record for the Plaintiff in the above entitled case?

/s/ R. T. JACOB,

Attorney for Plaintiff.

Service Accepted this 23rd day of September, 1946.

/s/ VICTOR E. HARR,

Attorney for Defendant.

[Endorsed]: Filed September 23, 1946. [37]

[Title of District Court and Cause.]

NOTICE TO PRODUCE

To: J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, Defendant, and Henry L. Hess, United States Attorney, Victor E. Harr, Assistant United States Attorney, Thomas R. Winter, Special Assistant, United States Attorney, Attorneys for Said Defendant:

You, and each of you, will please take notice that the Plaintiff requests you to produce at the pretrial conference on the above entitled action each and all of the following documents, to-wit:

1. The amended individual federal income tax return of C. B. Spencer d.b.a. Spencer Packing Company, prepared on form 1040, for the fiscal year beginning March 1, 1942, and ending February 28,

2. The individual federal income tax return of C. B. Spencer d.b.a. Spencer Packing Company, prepared on form 1040, for the fiscal year beginning March 1, 1943, and ending February 29, 1944.

3. The individual federal income tax return of C. B. Spencer d.b.a. Spencer Packing Company, prepared on form 1040, for the fiscal year beginning March 1, 1944, and ending February 28, 1945.

4. The claim of C. B. Spencer for the refund of tax illegally collected in the amount of \$93,565.04 filed with the Collector of Internal Revenue for the District of Oregon on or about April 21, 1945, a copy of which said claim marked Exhibit A is attached to and made a part of [38] Plaintiff's complaint herein.

And in the event of your failure to produce said document, the Plaintiff will introduce secondary evidence of the same.

/s/ R. T. JACOB,

/s/ RANDALL S. JONES,

Attorneys for the Plaintiff.

State of Oregon,

County of Multnomah—ss.

Due service of the within Notice to Produce is hereby accepted in Multnomah County, Oregon, this 18th day of October, 1946, by receiving a copy thereof, duly certified to as such by Randall S. Jones, of Attorneys for Plaintiff.

/s/ EDWARD B. TWINING,

Attorney for Defendant.

[Endorsed]: Filed October 18, 1946. [39]

[Title of District Court and Cause.]

MOTION TO CONTINUE PRE-TRIAL
CONFERENCE

Comes now J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, defendant, by Thomas R. Winter, Special Assistant to the United States Attorney for the District of Oregon, one of his attorneys, and moves the Court for an order continuing the pre-trial conference in the above case to on or after December 30, 1946.

In support of said motion, there is attached hereto an affidavit of said Thomas R. Winter, setting forth the grounds upon which said motion is based.

/s/ THOMAS R. WINTER,
Special Assistant to the United States Attorney for
the District of Oregon.

Copy received October 28, 1946.

/s/ R. T. JACOB.

[Endorsed]: Filed October 28, 1946.

State of Oregon,
County of Multnomah—ss.

Thomas R. Winter, being first duly sworn on oath, deposes and says that he is Special Assistant to the United States Attorney for the District of Oregon, and, as such, is charged with conducting the defense of this action.

The case involves the question of whether the plaintiff is entitled to a refund for the fiscal year

ended February 28, 1943, by reason of a net operating loss alleged to have been suffered in the fiscal year ended February 28, 1945, and to constitute a "net operating loss carryback," as defined by [40] Section 122 of the Internal Revenue Code, as amended. This action, therefore, necessitated the examination of the plaintiff's income tax returns for the fiscal years ended February 28, 1943, February 29, 1944, and February 28, 1945.

There is also pending in the Tax Court of the United States a case entitled *C. B. Spencer vs. War Department Price Adjustment Board, Docket No. 270R*. The petition in that case was filed August 13, 1945, and the petitioner, plaintiff here, seeks a re-determination of his "excessive profits," it being stated in the petition that the "alleged excessive profits determined by the respondent are in the sum of \$25,000 and such determination relates to petitioner's operations for the fiscal year ended February 28, 1943"; that any adjustment in that proceeding must be taken into account in this action now pending in this Court, wherein the plaintiff alleges he is entitled to the benefits of a net loss carry back for the year 1945.

That since the investigation of the plaintiff's income tax returns for the fiscal years ended February 28, 1943, February 29, 1944, and February 28, 1945, and since the setting of this case for pre-trial conference, information has been received that there was paid to Alice Barry, alias Mrs. Alice B. Spencer, Yakima, Washington, through H. G. Bauer Company, sole Sales Agent for the plaintiff, C. B. Spen-

cer, d.b.a. Spencer Packing Company, during the year 1943, the sum of \$9,500, which sum, it is indicated, was in truth and in fact the income of the plaintiff and was fraudulently omitted from his return.

That this matter is now under investigation by the investigating officers of the Bureau of Internal Revenue and it is believed their investigation and report cannot be completed prior to December 30, 1946.

That affiant is informed and believes that the investigation will disclose plaintiff has understated his income during one or all of the years here involved, and it will be necessary to file an amended answer and cross-complaint in the above action in order to protect the interests of the defendant and the United States and in order to avoid multiplicity of suits and properly adjudicate the plaintiff's tax liability.

Affiant further states that the issues as now formed are to be amended and that to require a pre-trial conference on the date set is prejudicial and not to the best interests of the parties to the action.

As additional and further grounds for the continuance of the pre-trial conference, affiant states that on or about October 18, 1946, there was served on the office of the United States Attorney a notice to produce certain documents, but the same was not received in affiant's office until October 21, 1946; that the documents called for are not in the possession of the United States Attorney or affiant and certified photostat copies of these original documents must be secured from Washington, D. C., and it is, therefore, impossible for these documents to be produced in

time for the pre-trial conference, as now set, but they will be secured as soon as possible.

/s/ THOMAS R. WINTER.

Subscribed and sworn to before me this 28th day of October, 1946.

[Seal] /s/ V. E. HARR,
Notary Public in and for the State of Oregon, Resid-
ing in Portland, Oregon.

My Commision Expires January 7, 1947.

[Endorsed]: Filed October 28, 1946. [42]

[Title of District Court and Cause.]

MOTION

The United States of America moves the Court for an Order permitting it to Interplead in this case for the purpose of asserting affirmatively a claim against C. B. Spencer, Plaintiff herein for income taxes and penalties of \$12,382.35 representing a net deficiency of Federal Income Taxes and penalties for the period involved in this action, which are due, owing, and unpaid.

Dated at Portland, Oregon, this 17th day of De-
cember, 1946.

/s/ HENRY L. HESS,
United States Attorney.

/s/ THOMAS R. WINTER,
/s/ JAMES P. GARLAND,

Special Assistants to the
Attorney General.

[Endorsed]: Filed December 17, 1946. [43]

[Title of District Court and Cause.]

ORDER

The United States of America having moved to interplead;

It Is Ordered that the United States of America may interplead in this action.

Dated at Portland, Oregon, this 17th day of December, 1946.

/s/ CLAUDE McCOLLOCH,
District Judge.

[Endorsed]: Filed December 17, 1946. [44]

In the District Court of the United States
for the District of Oregon
Civil Action No. 2949

C. B. SPENCER,

Plaintiff,

vs.

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
Defendant,

UNITED STATES OF AMERICA,

Interpleader.

AMENDED ANSWER FOR J. W. MALONEY
AND ANSWER FOR UNITED STATES OF
AMERICA.

The complaint is answered (by paragraphs corresponding to the paragraphs of the complaint) as follows:

1.

Admitted

2.

Admitted.

3.

Denied, except admitted that the amount in controversy exceeds \$3,000. It is averred that no claim for refund, sufficient to give this Court jurisdiction, was filed as required by law.

4.

Denied, except admitted that plaintiff filed on or about June 15, 1944, an amended individual income tax return for the fiscal year ending February 28, 1943, evidencing a total tax liability of \$141,722.80; admitted that plaintiff filed on or about June 14, 1944, an individual income and victory tax return for the fiscal year ending February 28, 1944, evidencing a total income and victory tax liability of \$43,588.18; admitted or averred that plaintiff paid to the Collector of Internal Revenue \$76,297.91 on or about October 8, 1943, \$1,394.59 on or about October 8, 1943, \$76,297.91 on or about February 19, 1944, and \$214.53, on or about March 22, 1945 [45]

5.

Denied.

6.

Denied, except admitted that plaintiff filed with the Collector of Internal Revenue for the District of Oregon, on or about April 21, 1945, an instrument purporting to be a claim for refund in the amount of \$93,565.04 for the fiscal year ending February 28, 1943, and admitted that Exhibit A of the complaint is a true copy of the instrument filed.

7.

Denied, except admitted that more than six months elapsed from the filing of the alleged claim for refund and the filing of the complaint.

As a Further Defense It Is Averred That:

1.

The alleged claim or instrument purporting to be a claim for refund concerned, and is stated therein to apply to, plaintiff's fiscal year 1943.

2.

That under the provisions of the Current Tax Payment Act of 1943, more particularly Section 6 thereof, the income taxes allegedly overpaid and sought to be recovered by plaintiff in this action are made applicable to and concerned plaintiff's fiscal year 1944, and not the fiscal year for which the alleged claim for refund was filed. It is further averred that plaintiff is not entitled to recover since there was no overpayment of income taxes for the fiscal year 1943, or for the fiscal year 1944.

3.

That this Court has no jurisdiction in that no adequate or sufficient claim for refund was filed as required by law.

Further Affirmative Defense

1.

That there was duly assessed a net deficiency of income taxes and penalties against C. B. Spencer,

plaintiff herein, on or about December 10, 1946, of \$12,382.35, which is now due, owing and unpaid. That said deficiency was based on the determination by the Commissioner of Internal Revenue, that sums of money in the aggregate amount of not less than \$22,498.05 received by Alice Barry Spencer during times relative hereto represented taxable income of C. B. Spencer. That C. B. Spencer directed such income to be paid to Alice Barry Spencer with intent to evade Federal Income Taxes.

2.

That plaintiff has not over-paid his Federal Income Taxes for the period involved in this action, but on the contrary has under-paid his taxes for the period here involved to the extent of not less than \$12,382.35. That any judgment which may be rendered in favor of the plaintiff in this action should be reduced by said amount of taxes and penalties assessed, outstanding, and unpaid.

Counter Claim of Defendant, United States of America

1.

The defendant, United States of America, herein alleges all the allegations contained in paragraph 1 of the preceding affirmative defense to the same extent as if such allegations were set forth herein in full.

2.

That the United States of America is entitled by reason of the above alleged assessments to affirmative judgment against C. B. Spencer, plaintiff herein, in the amount of \$12,382.35.

Wherefore, having fully answered, defendant J. W. Maloney prays judgment dismissing the plaintiff's complaint and for costs in the alternative, defendant, J. W. Maloney prays a set-off against any judgment which might be rendered in plaintiff's favor in the sum of \$12,382.35 with interests.

Defendant, the United States of America, prays an affirmative judgment against C. B. Spencer in the sum of \$12,382.35 with interests.

HENRY L. HESS,
United States Attorney.

THOMAS R. WINTER,
JAMES P. GARLAND,
Special Assistants to the
Attorney General.

[Endorsed]: Filed December 17, 1946. [47]

[Title of District Court and Cause.]

**REPLY TO COUNTER-CLAIM OF
THE INTERPLEADER**

For a First Reply to said counter-claim plaintiff denies and alleges:

1. Replying to paragraph 1 of said counter-claim plaintiff denies each and every allegation in-

corporated by reference in said paragraph, except that the alleged deficiency assessment of \$12,382.35 has not been paid and was based upon some purported determination of the Commissioner of Internal Revenue; and particularly denies that there was duly assessed a net deficiency of income tax and penalties in the sum of \$12,382.35, or any other sum, and that said sum, or any other amount, is now due and owing by him on account of said alleged assessment; and alleges he has no knowledge or information sufficient to form a belief as to the truth of the averment that Alice Barry Spencer received not less than \$22,485.05 during the times referred to in said counter-claim, and therefore denies that she received said amount or any other sum during said times; and further particularly denies that any sums of money, or parts thereof, received by said Alice Barry Spencer represented taxable income of the plaintiff.

2. Denies all of the allegation of said paragraph 2 of said counter-claim, and particularly denies that interpleader is entitled to receive from the plaintiff the sum of \$12,382.35 or any other amount by reason of the matters alleged in said counter-claim. [48]

For a Second Reply to said counter-claim plaintiff alleges:

No sum of money, or any part thereof, received by Alice Barry Spencer represented income upon which

the plaintiff is liable to the United States of America for income taxes. The alleged determination of the Commissioner of Internal Revenue, alleged by reference in the counter-claim, is based upon the erroneous theory that sums of money received by Alice Barry Spencer represented taxable income of C. B. Spencer. Consequently, the said alleged determination of the Commissioner of Internal Revenue is in all respects erroneous and illegal, and the alleged assessment of the deficiency in income taxes and penalties against the plaintiff based on said determination, also alleged by reference in said counterclaim, is in all respects erroneous and illegal.

Wherefore, Plaintiff demands that the United States take nothing by its said counter-claim, that the same be dismissed and that the plaintiff have and recover its costs and disbursements herein incurred.

JACOB, JONES & BRONN,
/s/ RANDALL S. JONES,
Attorneys for Plaintiff.

State of Oregon,
County of Multnomah—ss.

Due service of the within Reply is hereby accepted in Multnomah County, Oregon, this 28th day of February, 1947, by receiving a copy thereof, duly certified to as such by Randall S. Jones, one of the Attorneys for the Plaintiff.

/s/ HENRY L. HESS,
United States Attorney for
the District of Oregon.

[Endorsed]: Filed February 28, 1947. [49]

[Title of District Court and Cause.]

FINDINGS OF FACT AND CONCLUSIONS OF LAW

The above-entitled action came on regularly for trial on the 17th day of December, 1946, before the Honorable Claude McColloch, Judge of the above-entitled Court, plaintiff appearing in person and by his attorneys, Robert T. Jacob and Randall S. Jones, and defendant appearing by his attorneys, Thomas R. Winter, Special Assistant to the United States Attorney, and James P. Garland, Special Assistant to the United States Attorney General; trial was had without the intervention of a jury, the jury being waived in the manner provided by Rule 38 (d) of the Rules of Civil Procedure, stipulations by and between the parties hereto with respect to certain facts were dictated into the record of this action, witnesses were sworn and testified and exhibits were introduced in evidence, thereafter the case was continued to February 25, 1947, at which time depositions and further exhibits were introduced in evidence by the defendant, and based upon the admissions in the pleadings, said stipulations, testimony and evidence, after due consideration, the Court makes the following:

Findings of Fact

I.

At and during all times hereinafter mentioned C. B. Spencer, plaintiff, was and now is a resident of

the State of Oregon. During the taxable year ended February 28, 1943, and prior thereto plaintiff was engaged in the business of operating a cannery in the State of Oregon, and another cannery in the State of Washington. During the taxable years ended February 29, 1944, and February 28, 1945, plaintiff was engaged in the business of acquiring, owning, expanding, equipping and leasing food processing plants and providing, through guarantee and otherwise, adequate financing of the operations of such plants; and the said business during said times was regularly carried on by the plaintiff for profit. [50]

II.

At and during all the times hereinafter mentioned defendant was, and now is, the duly appointed, qualified and acting United States Collector of Internal Revenue for the District of Oregon.

III.

Jurisdiction of the within cause rests upon the provisions of Judicial Code of the United States, Sec. 24 as amended (28 USCA subdivision 5, Sec. 41), Sections 322 and 3772 of the United States Internal Revenue Code, as amended, and the provisions of Sections 23 and 122 of the Internal Revenue Code, as amended.

IV.

At and during all the times hereinafter mentioned plaintiff kept his books of account and made his income tax returns on the accrual and fiscal year

basis, and his fiscal year began on the first day of March of each calendar year and ended on the last day of the following February.

V.

On or about June 15, 1944, plaintiff filed with the defendant an amended individual income tax return (form 1040) for the taxable year ended February 28, 1943, evidencing a total income tax liability of plaintiff in the sum of \$141,722.80 for said year. On or about June 15, 1944, plaintiff filed with the defendant an individual income and victory tax return (form 1040) for the taxable year ended February 29, 1944, evidencing a combined income and victory tax liability of the plaintiff in the sum of \$152,619.84 for the taxable period beginning March 1, 1942, and ended February 29, 1944. Plaintiff paid to the defendant \$76,297.91 or on about October 8, 1943, \$1,394.59 on or about October 8, 1943, \$76,297.91 on or about February 19, 1944, and \$214.53 on or about March 22, 1945. Said payments fully paid all the tax liability of plaintiff evidenced by said tax returns.

VI.

On or about the 21st day of April, 1945, plaintiff filed with the defendant individual income tax return (form 1040) for the taxable year ended February 28, 1945, evidencing no tax liability against the plaintiff for said taxable year, but on the contrary evidencing a net loss for said taxable year in the sum of \$127,052.35, incurred in plaintiff's said business. [51]

VII.

The United States Commissioner of Internal Revenue caused all of the above-mentioned tax returns to be examined, and a revenue agent's report dated February 13, 1946, was made of said examination, in which said report, among others, the following adjustments were made in plaintiff's taxable income, to-wit:

- (a) The amount deductible for depreciation in the fiscal year ended February 28, 1945, is reduced by the sum of \$4,211.48, to-wit: from \$35,829.37 to \$31,617.89.
- (b) The amount deductible for depreciation in the taxable year ended February 29, 1944, is increased by the amount of \$4,211.48, to-wit: from \$19,971.16 to \$24,182.64. This adjustment and the one in sub-paragraph a. above are on account of the shortened amortization period authorized by a duly issued certificate of non-necessity.
- (c) The refund to plaintiff of \$687.62 previously paid by him on Oregon income tax is added to the plaintiff's income tax taxable income for the year ended February 29, 1944, (with respect to victory tax taxable income, see Finding IX and Con. VII).
- (d) The additional sums of \$224.32, \$1.558.24, \$1,126.11 and \$269.90 totaling \$3,278.57 are added to taxable income for the fiscal year ended February 28, 1943, the first said amount being a sum that should be trans-

ferred from surplus to income; the second said amount being an adjustment of a deduction for Washington Sales Tax, and the two last-mentioned amounts being capital items that had been erroneously charged to expense.

(e) The sum of \$186.22 is added to the amount allowed as depreciation for the taxable year ended February 28, 1943.

Each and all of the foregoing adjustments are proper and correct and were accepted as such by the parties hereto. The facts bearing upon all other adjustments made in said report insofar as material to the issues of this case are herein elsewhere set forth.

VIII.

During the taxable year ended February 28, 1945, Spencer Dehydrator, Inc., an Oregon corporation, owed the plaintiff the sum of \$61,115.48, on account of accounts payable of said corporation which plaintiff had previously guaranteed and did pay, and on account of notes payable of said corporation upon which plaintiff was surety and which plaintiff did pay (except for the sum of \$3.68 which was credited to plaintiff's income on February 28, 1946, and was disregarded at the trial and beyond this mention is also disregarded in these findings). And, during said taxable year Spencer Packing Company of Yakima, a Washington corporation, owed the plaintiff the sum of \$33,966.02 on account of unpaid rent, sums advanced by plaintiff to said corporation to pay promissory notes of said corporation upon

which plaintiff was surety and which sums were used by it to pay said notes, lug boxes rented to said corporation by plaintiff and not returned by it to him because they [52] had become broken, and money belonging to him and collected by said corporation but not paid over to him by it. The said sums owed to plaintiff by corporations were unpaid balances on open accounts receivable of plaintiff, and no open accounts payable of said corporations, and were and are debts which arose in the course of plaintiff's said business and were not contributions to the capital of the said corporations or to the capital of either of them. Each of the said corporations was completely liquidated within said taxable year and since February 15, 1945, neither of them has engaged in any business, and neither of them has had any income or assets. That prior to the liquidation of said corporations they were engaged in the business of food processing. Each of the said debts, and the whole thereof, became worthless in the said taxable year, and the loss sustained by plaintiff from the worthlessness of the said debts was incurred by him in his said business and was and is attributable to the operation of said business regularly carried on by the plaintiff.

IX.

In plaintiff's said return for the taxable year ended February 28, 1945, a deduction was taken for bad debts in the amount of \$107,567.51. This deduction was for the two debts mentioned in paragraph VIII above. At the time the return was

made the plaintiff's books showed the amount owed him by the Dehydrator Corporation was in the sum of \$73,601.49, which with the said sum of \$33,966.02 owed to him by Spencer Packing Company of Yakima make up the said amount of \$107,567.51. The said sum of \$73,601.49 represented the balance due plaintiff after applying all available credits against his account with the Spencer Dehydrators, Inc., except there was erroneously included in said balance the sum of \$223.21 which was due and owing by plaintiff during said taxable year on account of taxes on real and personal property. Said taxes, however, were against the Dehydrator plant which plaintiff was renting to said Corporation in the course of his said business. One of the said credits to Spencer Dehydrator, Inc., was for an account of Spencer Dehydrators, Inc., against the Commodity Credit Corporation, which plaintiff had taken over. Subsequent to the filing of said return and the refund claim hereinafter mentioned, an audit of the last mentioned account was made by representatives of said Commodity Credit Corporation, and it was determined by said audit that the Commodity Credit Corporation owed \$12,262.82 on said account in addition to the amount showed on the books of Spencer Dehydrators, Inc., on February 15, 1945, which was the day said account was taken over as a credit by the plaintiff. The [53] said sum was entirely earned by said Spencer Dehydrator, Inc., and it was entitled to receive said amount from the Commodity Credit Corporation prior to February 15, 1945, and is applied as a fur-

ther credit and with said taxes reduces plaintiff's said bad debt against Spencer Dehydrator, Inc., from \$73,601.49 to the sum of \$61,115.46 as specified in said paragraph VIII, and reduces his total bad debts for said taxable year from said sum of \$107,567.51 to the amount of \$95,081.48.

X.

An adjustment was made in said revenue agent's report whereby plaintiff's net income for the taxable year ended February 28, 1943, was reduced by \$25,000.00 with the following explanation:

"To allow refund of excess profits made under Sec. 3806 of Internal Revenue Code."

It appears of record that there is now pending on appeal before the Tax Court of the United States the renegotiation question of whether or not plaintiff's net income for said taxable year includes excessive profits in said amount.

XI.

The said refund of \$687.62 received by plaintiff from the State of Oregon was not taken as a deduction in computing plaintiff's victory tax net income for the taxable year ended February 29, 1944.

XII.

The labels owned by the plaintiff and on hand at the end of the taxable year ended February 28, 1943, were then valueless, and the cost thereof in the sums shown in said revenue agent's report were charged to expense by the plaintiff.

XIII.

Plaintiff's gross income from his said business for the taxable year ended February 28, 1945, was in the sum of \$33,562.28. Plaintiff took business deductions for said taxable year in the sum of \$17,217.75 about which there is no dispute by and between the parties hereto. This amount, together with said bad debts in said sum of \$95,081.48 and taxes in said sum of \$223.21 and depreciation in said sum of \$31,617.89 give plaintiff business deductions for said taxable year in the sum of \$144,-140.33. Plaintiff's net loss for said taxable year attributable to the operations of his said business was and is in the sum of \$110,578.05 (i.e. \$33,562.28-\$144,140.33 = (\$110,578.05)). [54]

XIV.

During said taxable year ended February 28, 1945, plaintiff sold property which had been held by him for more than 6 months and realized a gain on account of such sales in the total sum of \$17,-141.39. There are no other gains, losses or deductions to be taken into account in computing plaintiff's "net operating loss" for said taxable year in accordance with the provisions of Sec. 122 of the Internal Revenue Code. Plaintiff sustained a "net operating loss" for said taxable year, and a "net operating loss carry-back" for the taxable years ended February 28, 1943, and February 29, 1944, within the meaning of said code section in the sum of \$93,436.66, and the same was incurred in and is and was attributable to the operation of his said business regularly carried on by him.

XV.

Plaintiff inadvertently overstated his gross income for the taxable year ended February 28, 1943, by the sum of \$510.15, and his gross income for said year from the business in which he was then engaged was in the sum of \$2,275,474.85 and not \$2,275,985.00 as set forth in said return for said year. Plaintiff took business deductions for said taxable year to the extent of \$2,080,356.36 about which there is no dispute by and between the parties hereto, and which sum is less the said \$3,278.57 mentioned in paragraph VII (d) that is added back to income. Said sum of \$2,080,356.36 together with said "net operating loss carry-back" of \$93,436.66 and said depreciation in the amount of \$186.22 (paragraph VII (e)) give business deductions for said taxable year in the total amount of \$2,173,-979.24. Plaintiff's net income for said taxable year from said business was in the sum of \$101,495.61. He had other income for said year in the amount of \$506.24, and other deductions totaling \$1,684.12 about which there is no dispute. Plaintiff's personal exemptions and credits for dependents for said taxable year were in the sum of \$1,900.00, and his earned income credit for said year was in the sum of \$1,400.00. His surtax net income for said taxable year was in the sum of \$98,417.73 and his normal tax net income for said year was in the sum of \$97,-017.73. The total amount of plaintiff's income tax liability for said taxable year computed according to the provisions of the revenue act then in force and without regard to the provisions of the Current

Tax Payment Act of 1943 was and is in the sum of \$63,742.71, and not in the sum of \$141,722.80 as shown on his said return for said year. [55]

XVI.

Plaintiff's income tax net income for the taxable year ended February 29, 1944, was in the sum of \$68,748.98 and not \$72,272.84 as shown on said return. Said amount of \$68,748.98 takes into account the adjustments mentioned in paragraphs VII (b) and (c). Plaintiff's victory tax net income for said taxable year was in the sum of \$69,239.96 and not \$73,451.44 as shown on said return. Said amount of \$69,239.96 also takes into account the said increased depreciation set forth in paragraph VII (b). The total amount of plaintiff's combined income and victory tax liability for said taxable year computed according to the terms of the revenue act then in force but without taking into account the forgiveness features of the Current Tax Payment Act of 1943 was and is in the sum of \$40,872.39, and not in the sum of \$43,588.18 as shown on said return for said taxable year.

XVII.

That plaintiff's total income and victory tax liability for the taxable period commencing March 1, 1942, and ended February 29, 1944, computed in accordance with the forgiveness provisions of the Current Tax Payment Act of 1943 was and is in the sum of \$73,960.81 and not in the sum of \$152,619.84 as shown on said return for the taxable year ended February 29, 1944.

XVIII.

That prior to having sustained said "net operating loss carry-back" and by April 21, 1945, plaintiff paid to the defendant the total amount of \$152,619.84 on account of his combined income and victory tax liability for the taxable period ended February 29, 1944, all as more particularly set forth in paragraph V hereof. He overpaid his said income and victory tax liability for said taxable period in the sum of \$78,659.03, and defendant has not refunded the same or any part thereof to plaintiff.

XIX.

On or about April 21, 1945, plaintiff duly filed with the defendant a claim for the refund to him of the sum of \$93,565.04, which claim was based on the ground presented in the complaint herein, namely, that he is entitled to said "net operating loss carry-back," and that his income and victory taxes for the taxable period ended February 29, 1944, recomputed so as to include said "net operating loss carry-back" results in an overpayment of his income and victory taxes for said period. More than six months elapsed from the filing of said claim to the date of the filing of this action, and no notice of allowance or disallowance has been received from the Commissioner. [56]

XX.

Plaintiff made no statements or representations in any of the above-mentioned returns with an

intent to evade federal taxes. Plaintiff did not direct that any money be paid to Alice Barry with an intent to evade federal income taxes, said Alice Barry being misnamed in the answer as Alice Barry Spencer. No money received by said Alice Barry during any of the times herein mentioned represented taxable income of the plaintiff. The deficiency assessed against the plaintiff by the United States Commissioner of Internal Revenue on or about December 10, 1946, in the sum of \$12,382.35 was based on an erroneous determination by the said Commissioner that certain sums of money received by Alice Barry represented taxable income of the plaintiff.

Based on the foregoing Findings of Fact, the Court makes the following:

Conclusions of Law

I.

This Court has jurisdiction of this action and of the parties hereto.

II.

During the taxable years ended February 28, 1943, February 29, 1944, and February 28, 1945, plaintiff was engaged in a business regularly carried on by him within the meaning of Section 23, (k), (4) and Section 122, (d) (5) of the Internal Revenue Code of the United States of America.

III.

The said sums of \$61,115.46 and \$33,966.02 owed to plaintiff by said Spencer Dehydrator, Inc., and Spencer Packing Company of Yakima, respectively, were debts which became worthless within the taxable year ended February 28, 1945, and plaintiff incurred a loss in his said business during said taxable year in the total sum of \$95,081.48 from the worthlessness of said debts, all within the meaning of Section 23, (k) of the Internal Revenue Code.

IV.

Plaintiff is entitled to a business deduction for the taxable year ended February 28, 1945, in the sum of \$223.31 on account of taxes then due and owing from him on real and personal property used by him in his said business.

V.

Plaintiff has and is entitled to a "net operating loss carry-back," within the meaning of Section 122 of the Internal Revenue Code, for the taxable period beginning March 1, 1942, and ended February 29, 1944, in the sum of \$93,436.66. [57]

VI.

Pursuant to the provisions of Section 403 (e), (1) of the Sixth National Defense Appropriation Act of 1942, as amended by Section 701 of the Revenue Act of 1943 the Tax Court of the United States has exclusive jurisdiction to finally determine the amount, if any, of excessive profits received by

plaintiff during the taxable year ended February 28, 1943. In the absence of such final determination, this District Court of the United States may decide the case at bar and give judgment herein without taking into further consideration the said purported adjustment on account of alleged excessive profits.

VII.

The said refund of \$687.62 received by plaintiff from the State of Oregon should not be included in his victory tax net income for the taxable year ended February 29, 1944.

VIII.

The cost of the labels owned by plaintiff at the end of the taxable year ended February 28, 1943, were properly charged to expense by the plaintiff and should not be added back to income.

IX.

Defendant wrongfully withholds from the plaintiff the sum of \$78,659.03, and plaintiff is entitled to recover of and from the defendant the sum of \$78,659.03, together with interest thereon at the rate of 6% per annum from April 21, 1945, as provided by law, and his costs and disbursements herein incurred.

X.

Plaintiff does not owe the United States of America the said sum of \$12,382.35 or any other amount of income or victory taxes for any of the taxable

years involved in this case. The said deficiency assessed against plaintiff in the sum of \$12,382.35 was and is wrongful and invalid. Defendant is not entitled to offset any sum whatsoever against the said amount of \$78,659.03 and interest thereon due and owing to the plaintiff, and the United States of America, interpleader herein, is not entitled to recover anything from the plaintiff on account of its counter-claim herein.

Dated this 19th day of June, 1947.

CLAUDE McCOLLOCH,
Judge.

Service accepted this 19th day of June, 1947.

/s/ HENRY L. HESS,
United States District Attorney for the District
of Oregon.

True copy of the foregoing Findings of Fact and Conclusions of Law were this day duly mailed to Mr. Thomas R. Winter, Smith Tower Bldg., Seattle, Washington, with postage thereon fully prepaid.

/s/ RANDALL S. JONES.

[Endorsed]: Filed June 19, 1947. Lowell Munderoff, Clerk. [58]

In the District Court of the United States
for the District of Oregon

Civil Action No. 2949

C. B. SPENCER,

Plaintiff,

vs.

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
Defendant,

UNITED STATES OF AMERICA,

Interpleader.

JUDGMENT

The above-entitled action came on regularly for trial on the 17th day of December, 1946, before the Honorable Claude McColloch, Judge of the above-entitled Court, plaintiff appearing in person and by his attorneys, Robert T. Jacob and Randall S. Jones, and defendant appearing by his attorneys, Thomas R. Winter, Special Assistant to the United States Attorney, and James P. Garland, Special Assistant to the United States Attorney General; trial was had without intervention of a jury, the jury being waived in the manner provided by Rule 38 (d) of the Rules of Civil Procedure, stipulations by and between the parties hereto with respect to certain facts were dictated into the record of this action, witnesses were sworn and testified and exhib-

its were introduced in evidence, thereafter the case was continued to February 25, 1947, at which time depositions and further exhibits were introduced in evidence by the defendant, and based upon the admissions in the pleadings, said stipulations, testimony and evidence, after due consideration, on the 19th day of June, 1947, the Court made special Findings of Fact and Conclusions of Law, which are now on file herein. [59]

Now, Therefore, on motion of the Plaintiff for judgment and based upon said Findings of Fact and Conclusions of Law:

It Is Hereby Ordered and Adjudged that the Plaintiff have and recover of and from the Defendant herein the sum of \$78,659.03 with interest thereon at the rate of 6% per annum from the 21st day of April, 1945, as provided by law, together with Plaintiff's costs and disbursements herein incurred and herein taxed in the amount of \$.....

Dated this 24th day of June, 1947.

/s/ CLAUDE McCOLLOCH,
Judge.

Entered in docket June 24, 1947.

[Endorsed]: Filed June 24, 1947. [60]

[Title of District Court and Cause.]

NOTICE OF APPEAL

To: C. B. Spencer, Plaintiff named above, and Robert T. Jacob and Randall S. Jones, Attorneys for Plaintiff.

You and each of you will please take notice that the Defendant J. W. Maloney, and Inte- pleader, United States of America, appeal to the Circuit Court of Appeals for the Ninth Circuit, from the Judgment entered in this action on June 24, 1947.

HENRY L. HESS,
United States Attorney for
the District of Oregon.

THOMAS R. WINTER,
Special Assistant to the
United States Attorney.

/s/ VICTOR E. HARR,
Assistant United States
Attorney. [61]

[Affidavit of service by mail attached.]

[Endorsed]: Filed Sept. 19, 1947. [62]

In the District Court of the United States
for the District of Oregon

Civil No. 2949

C. B. SPENCER,

Plaintiff,

vs.

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon,
Defendant.

ORDER

This Matter coming on to be heard ex parte this day upon motion of defendant, through his attorney, Henry L. Hess, United States Attorney for the District of Oregon, and Victor E. Harr, Assistant United States Attorney, for an order extending time for the filing of the record on appeal and docketing the within action in the Circuit Court of Appeals, to enable the Department of Justice to have additional time to consider said appeal, and the Court being fully advised in the premises,

It Is Ordered that the time for filing the within appeal and docketing the action be, and it is hereby extended to ninety days from the first date of the Notice of Appeal.

Made and entered at Portland, Oregon, this 17th day of October, 1947.

/s/ CLAUDE McCOLLOCH,
Judge.

[Endorsed]: Filed Oct. 17, 1947. [63]

[Title of District Court and Cause.]

STATEMENT OF POINTS ON WHICH DEFENDANT INTENDS TO RELY ON APPEAL.

The defendant, having taken an appeal to the United States Circuit Court of Appeals for the Ninth Circuit from the judgment rendered by the District Court for the District of Oregon, hereby designates the following points to be relied on in the prosecution of said appeal:

I.

That the District Court erred in finding, concluding and holding that plaintiff was entitled to a net operating loss carryback, under Section 122 of the Internal Revenue Code.

II.

That the District Court erred in finding and concluding that plaintiff was, during the taxable year, engaged in the trade or business regularly carried on by him, of financing, acquiring, owning, expanding, equipping and leasing food processing plants.

III.

That the District Court erred in finding and concluding that the sums advanced by plaintiff to or on behalf of the corporations here involved, the Spencer Dehydrators, Inc., and the Spencer Packing Company of Yakima, constituted bad debts and did not constitute capital investments by plaintiff in the aforementioned corporations.

IV.

That the District Court erred in concluding that during the taxable years ending February 28, 1943, February 29, 1944, February 28, 1945, plaintiff was engaged in a business regularly carried on by him within the meaning of Section 23 (k) (4) and Section 122 (d) (5) of the Internal Revenue Code. [64]

V.

That the District Court erred in concluding that the sums of \$61,115.46 and \$33,966.02 were owed to plaintiff by the Spencer Dehydrators, Inc., and the Spencer Packing Company of Yakima, and that such amounts were debts which became worthless within the taxable year ending February 28, 1945, and concluding that plaintiff incurred a loss in a business regularly carried on by him during said period in the total sum of \$95,081.48, from worthless debts within the meaning of Section 23 (k) of the Internal Revenue Code.

VI.

That the District Court erred in concluding that plaintiff was entitled to a net operating loss carry-back within the meaning of Section 122 of the Internal Revenue Code for the taxable period beginning March 1, 1942, and ending February 29, 1944, in the sum of \$93,436.66.

VII.

That the District Court erred in granting judgment in favor of plaintiff and against the United

States to the extent that the judgment was based on the allowance of the aforementioned net operating loss carry-back under Section 122 of the Internal Revenue Code.

Dated this 17th day of December, 1947.

/s/ HENRY L. HESS,
United States Attorney.

/s/ FLOYD D. HAMILTON,
Assistant United States
Attorney,
Attorneys for Defendant.

[Affidavit of service by mail attached.]

[Endorsed]: Filed Dec. 17, 1947.

[Title of District Court and Cause.]

DESIGNATION OF CONTENTS
OF RECORD ON APPEAL

To the Clerk of the Above-entitled Court:

Defendant, J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, hereby designates that portion of the record in this case to be contained in the record on appeal, which is described as follows:

1. All pleadings.
2. Transcript of proceedings of the trial.
3. Leases between plaintiff and Spencer Dehydrators, Inc., and between plaintiff and Spencer Packing Company of Yakima.

4. Findings of Fact and Conclusions of Law.
5. Judgment.
6. Notice on Appeal.
7. Order Extending Time to Docket Record on Appeal.
8. Statement of Points on which Defendant intends to Rely on Appeal.
9. This Designation.

Dated this 17th day of December, 1947.

/s/ HENRY L. HESS,
United States Attorney.

/s/ FLOYD D. HAMILTON,
Assistant United States
Attorney.

[Affidavit of service by mail attached.]

[Endorsed]: Filed December 17, 1947. [67]

[Title of District Court and Cause.]

**SUPPLEMENTAL DESIGNATION OF
CONTENTS OF RECORD ON APPEAL**

To the Clerk of the Above Entitled Court:

Defendant, J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, in addition to that portion of the record in this case by him designated on December 17, 1947, to be contained in the record on appeal, further designates the Order of the Circuit Court of Appeals for the Ninth Circuit, dated December 18, 1947, ex-

tending the time for filing the record on appeal in the within action for thirty days from and after December 18, 1947, to be contained in the record on appeal.

Dated this 2nd day of January, 1948.

HENRY L. HESS,
United States Attorney.

FLOYD D. HAMILTON,
Assistant United States
Attorney.

[Affidavit of service by mail attached.] [68]

[Endorsed]: Filed Jan. 2, 1948.

United States Circuit Court of Appeals
For the Ninth Circuit

No. Civ. 2949

J. W. MALONEY,

Appellant,

vs.

C. B. SPENCER,

Appellee.

ORDER

This matter coming on to be heard this date upon motion of Henry L. Hess, United States Attorney for the District of Oregon, and Floyd D. Hamilton, Assistant United States Attorney, for an Order extending time for filing of the record and docket-

ing the appeal in the within action for the reason that appellant has filed in the District Court a Designation of Contents of Record on Appeal and a Statement of Points upon which Defendant Intends to Rely on Appeal but the District Court will not be able to prepare and docket the record on appeal in the Circuit Court of Appeals within the time set therefor, and the Court having considered said motion and supporting affidavit and being advised in the premises,

It Is Ordered that the time for filing the record on appeal in the within action be, and it is hereby, extended thirty (30) days from and after December 18, 1947.

Made and entered at San Francisco, California, this 18th day of December, 1947.

FRANCIS A. GARRECHT,
Judge.

A true copy.

Attest: Dec. 18, 1947.

[Seal] /s/ PAUL P. O'BRIEN,
Clerk.

[Endorsed]: Filed December 18, 1947. Paul P. O'Brien, Clerk.

[Endorsed]: Filed Dec. 23, 1947. Lowell Munderff, Clerk; by F. L. Buck, Chief Deputy.

In the District Court of the United States
For the District of Oregon

Civil 2949

C. B. SPENCER,

Plaintiff,

vs.

J. W. MALONEY, Collector of Internal Revenue
for the District of Oregon,

Defendant.

United States of America,

Interpleader.

DOCKET ENTRIES

1945

Oct. 27—Filed Complaint.

Oct. 29—Issued summons—to marshal.

Oct. 30—Filed summons with marshal's return.

Nov. 9—Filed affidavit of service.

Dec. 29—Filed petition of Deft. for Extension of
Time.

1946

Jan. 5—Filed affidavit in opposition to petition
for extension of time.

Jan. 14—Record of hearing on motion for exten-
sion of time and order entered setting for
pre-trial for Jan. 28, 1946. Fee.

Jan. 28—Filed answer.

Feb. 5—Filed motion for preliminary hearing as
to jurisdictional defense.

1946

Feb. 11—Entered order to set motion for preliminary hearing for Feb. 25. Fee.

Feb. 25—Record of pre-trial continued to Mar. 4. Notice mailed.

Mar. 4—Filed and entered pre-trial order. Fee.

Mar. 4—Entered order to submit cause on briefs and allowing to March 11, 1946 for briefs. Fee.

Mar. 18—Filed plaintiff's brief.

Mar. 18—Filed defendant's memorandum of jurisdiction.

July 8—Record of opinion. Attorneys notified. Fee.

Sept. 23—Entered order setting pre-trial conference for Oct. 28, 1946. McC.

Sept. 23—Filed notice of appearance of Randall S. Jones as associate counsel of record for plaintiff.

Oct. 18—Filed notice to Produce.

Oct. 28—Filed motion to continue pre-trial conference.

Oct. 28—Record of hearing on motion of deft. for continuance of pre-trial hearing; record of pre-trial hearing; order amending complaint by interlineation and order allowing filing of amended answer; and order setting for trial on Dec. 17, 1946. McC.

Nov. 6—Filed motion of plaintiff for order to withdraw exhibits.

1946

Nov. 6—Filed and entered order to withdraw exhibits. McC.

Dec. 13—Entered order admitting James P. Garland for purposes of this case and order denying motion of deft. for continuance of trial date. McC.

Dec. 17—Filed motion for order permitting U. S. to interplead.

Dec. 17—Filed and entered order permitting U. S. to interplead. McC.

Dec. 17—Filed amended answer for deft. Maloney and answer of United States. [71]

Dec. 17—Lodged pre-trial order. (Exhibits in Box —Record Room.)

Dec. 17—Record of trial before court and order continuing to further order (Depositions to complete). McC.

Dec. 21—Entered order setting Jan. 27, 1947, for conclusion of trial. Notified McC.

1947

Jan. 6—Entered order resetting for Feb. 25, 1947, for conclusion of trial. Notified McC.

Jan. 11—Filed Transcript of Proceedings Dec. 17, 1946.

Jan. 22—Filed Depositions of Harold G. Bauer and Alice G. Barry.

Feb. 25—Entered record of further trial before court; briefs: plaintiff by March 31, deft. by April 1, 1947. McC.

1947

Feb. 28—Filed reply to counterclaim of the inter-pleader.

Mar. 3—Filed Transcript of Proceedings Feb. 25, 1947.

May 15—Entered order allowing four weeks' additional time for deft. to file brief. McC.

May 20—Filed Brief for Deft. and U. S.

May 22—Entered order for plaintiff to prepare and submit Findings of Fact and Conclusions of Law and Judgment. Notices. McC.

June 19—Filed and entered Findings of Fact and Conclusions of Law. Notices. McC.

June 24—Filed and entered Judgment for plaintiff. Notices. McC.

June 24—Filed statement of costs and disbursements claimed by plaintiff.

Sept. 3—Filed judgment roll.

Sept. 19—Filed notice of appeal—notices mailed by U. S. Attorneys.

Oct. 17—Filed and entered order extending time for 90 days from notice of appeal to file appeal.

Dec. 17—Filed designation of contents of record on appeal.

Dec. 17—Filed statement of points.

Dec. 23—Filed copy of order of C. C. of A extending time to January 17, 1948, to appeal.

1948

Jan. 2—Filed supplemental designation of contents of record on appeal.

United States of America,
District of Oregon—ss.

CLERK'S CERTIFICATE

I, Lowell Mundorff, Clerk of the District Court of the United States for the District of Oregon, do hereby certify that the foregoing pages numbered from 1 to 73, inclusive, constitute the transcript of record on appeal from a judgment of said court in a cause therein numbered Civil 2949, in which C. B. Spencer is plaintiff and appellee, and J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, is defendant and appellant; that the said transcript has been prepared by me in accordance with the designation and supplemental designation of contents of the record on appeal filed by the appellant, and in accordance with the rules of this court; that I have compared the foregoing transcript with the original record thereof and that it is a full, true and correct transcript of the record and proceedings had in said court in said cause, in accordance with the said designations, as the same appear of record and on file in my office and in my custody.

I further certify that I have enclosed under separate cover a duplicate transcript of the testimony and proceedings dated December 17, 1946, and a duplicate transcript of the proceedings dated February 25, 1947, pages 126-146 inclusive, taken and filed in this office in this cause.

In testimony whereof I have hereunto set my

hand and affixed the seal of said court in Portland,
in said District, this 15th day of January, 1948.

[Seal] LOWELL MUNDORFF,

Clerk.

By F. L. BUCK,

Chief Deputy.

In the District Court of the United States
for the District of Oregon

Civil No. 2949

C. B. SPENCER,

Plaintiff,

vs.

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
Defendant.

Portland, Oregon, December 17, 1946
10 A.M.

Before: Honorable Claude McColloch,
Judge.

Appearances:

Mr. Robert T. Jacob and Mr. Randall S. Jones,
Attorneys for Plaintiff.

Mr. Thomas R. Winter, Special Assistant to the
United States Attorney, and Mr. James P. Garland,
Special Assistant to the Attorney-General, Attor-
neys for Defendant.

PROCEEDINGS

Mr. Garland: If your Honor please, we find it
necessary to file a motion for the United States to

intervene in this case. There is an additional assessment which was made. We had notice of it by telegram this morning, or Saturday, rather, so, in order to put the pleadings in a condition where we can ask for an affirmative judgment in this case, we must ask that the United States be made a party for that purpose. The statute requires that a suit to recover taxes must be brought in the name of the United States, so we would like to file that motion now. If the motion is granted, we have an amended answer by the Collector—on behalf of the Collector—an answer on behalf of the United States.

The Court: We have got to have your names on these pleadings, too.

Mr. Garland: Thank you, your Honor.

The Court: You will put it on there?

Mr. Garland: Yes.

Mr. Jones: We have no objection to the filing of the motion.

The Court: It may be filed.

Mr. Winter: The motion being granted, now, we ask leave to file the amended answer.

The Court: That may be done. [2*]

Mr. Jones: If the Court please, we have no objection to filing the amended answer but, not having any advice as to exactly what it is, we would like a few minutes at least to look it over.

If the Court please, there is a counterclaim in this case. It would require a reply and we should like to reply by way of general denial to the counterclaim of the defendant United States of America.

* Page numbering appearing at top of page of Reporter's certified Transcript of Record.

The Court: It may be filed.

Mr. Garland: May it please the Court, I would like to make a statement in regard to this affirmative defense. I think this would be the appropriate time to do it, and it may make things easier for all of us.

The taxes assessed now are based upon the ground that Spencer diverted certain income over which he had control to the support of Alice Berry of Yakima. It will require some evidence to show a motive on his part or a desire to render that support, so we will ask now for an admission which may relieve us of the necessity of going into that question. We will ask counsel to admit, in lieu of evidence on that point, that Mr. C. B. Spencer contrived to support Alice Berry and her child and had at least a moral obligation to support them.

Mr. Jones: We are not going to make any admission at all along any lines of this counterclaim. [3]

Mr. Garland: I thought it appropriate to ask at least for an admission.

Mr. Jones: I would like to add, if the Court please, that I do not believe the rules require me to file an affirmative pleading in the nature of a reply to their further affirmative defense at the top of page 3.

Mr. Garland: If the rules do, we will waive.

Mr. Jones: I was going to say, if they do, I want to file one. I believe there is an implied denial there.

When we were having the pre-trial conference, we closed with my dictating a request into the record to produce certain books that we did not have at the time, and I have since had them numbered together

with three statements or four statements which analyzed them, and I should like at this time to have them considered a part of the pre-trial exhibits of the plaintiff. They are numbered consecutively from Plaintiff's Pre-Trial Exhibit 65 to and including Plaintiff's Pre-Trial Exhibit 73. They are statements of our income and expenses, profit and loss statements, for the three years as taken from the books which make up the first five of the exhibits, and the last one, No. 73, is a take-off from the books of our depreciation schedule.

Mr. Garland: I understand that these are for identification only?

Mr. Jones: For identification. There is no pre-trial [4] order in this case, your Honor. The reason for that is we were not quite sure what would develop along the lines that have just developed. Before that, I had a draft of a pre-trial order which contained certain admissions that the plaintiff is willing, and continues to be willing, to make in this case. I am very glad to hand counsel a copy of it and to hand in the original draft to the Court. It has not been agreed upon, but insofar as it contains admissions on our part we are quite willing to abide by them.

The Court: Give Mr. Garland a copy.

Mr. Garland: We have it right here.

Mr. Jones: This is a case brought by Mr. Spencer, as an individual—

Mr. Winter: As part of the pre-trial, I want to identify two exhibits on our part. I advised the Court that as soon as we received exhibits we would put them in the pre-trial, your Honor.

We would like to have identified as Defendant's Pre-Trial Exhibit, first, a certified copy of the assessment list, signed by the Commissioner, and, second, a certified copy of the telegram with the certificate of the Collector showing when it was received. At the proper time, we wish to substitute photostatic copies of the returns which have been identified in the pre-trial record. We have copies of the original returns. [5]

(Documents referred to thereupon marked Defendant's Pre-Trial Exhibits 74 and 75, respectively.)

Mr. Jones: In this case, your Honor, Mr. Spencer is bringing an action based on a net operating loss or carryback, due to a net operating loss which he sustained in the year ending 1945. His fiscal year begins as of March 1st and ends February 28th and, while he makes his tax return for this particular year on the 1944 tax return form, we ordinarily refer to it as his tax for the year ended February 28, 1945.

During that year, he experienced a net operating loss which, with the adjustment which this pre-trial order takes into account, amounts to a total in the sum of \$93,436.66.

The Revenue Agent made an audit and made a report which has been identified herein as Pre-Trial Exhibit No. 63. In that, he made certain adjustments, all of which but one we admit are correct. One of those is the matter of inventory. I understand you are conceding the inventory.

If our evidence shows we are correct on the inventory item, then, the carry-back will be \$93,000 under our version of the facts in this case.

The crucial point, as I see it, will turn on whether or not we are entitled to a net operating loss carry-back in the sum of some \$93,000, as we contend, or whether we are entitled to it in the sum of some \$15,000, as the Agent's report indicates.

Now, then, the difference between the amount of \$15,000 and \$93,000 largely concerns what we claim are two bad debts and what the Agent claims are contributions to capital stock in addition to the original investment.

Mr. Spencer, at the time involved, which started with the fiscal year 1942, or ending in February, 1943, to the fiscal year ending in 1945 in February, for the last two of those years he was engaged in the business of owning, acquiring, leasing and financing of canneries and packing plants. During that time he owned and leased three plants, one of which we will refer to as the Lebanon plant, which was one he built in 1936 and operated as an individual up until March 1, 1943. The other, he acquired along the first part of the period, the dehydrator, which was an old prune drier converted into a dehydrator at Lebanon. There was a third plant at Yakima, Washington. He leased the original unit of that plant and then purchased adjoining land and built it up.

All of those plants, owned by him as an individual, were leased by him and his wife—the old Lebanon plant, the one built in 1936, to a corporation which

was organized and which went into business as of March 1, 1943, called the [7] Spencer Packing Company of Lebanon. The converted prune drier, converted into a dehydrator plant, was leased by Mr. Spencer and Mrs. Spencer to a corporation called the Spencer Dehydrators, Inc. The original leased unit and the afterwards acquired and owned unit of the Yakima plant were leased by Mr. and Mrs. Spencer to a corporation called the Spencer Packing Company of Yakima.

The reason why there are so many books and records here is that they represent the accounts of the three corporations and of Mr. Spencer. His income resulted in rents that he received from these three corporations. He drew no salary from any one of them. He was an officer and director of all of them.

In the leases which we have identified as pre-trial exhibits, there is a clause called the financing clause that required him to guarantee and to pledge his property, the property covered by the leases, in order to secure operating capital, and, in turn for that, he received the rentals. His books take into account the rentals, and also there were certain accounts between him and the corporations that resulted, at the time of the liquidation of the Yakima Corporation, in a balance due him of approximately \$78,000.

When the corporations were liquidated, he took over the assets, paid one other bill of \$30.22, and applied [8] the balance of the assets, some \$40,000, towards the \$78,000, scaling that bill down to \$33,000. That \$33,000 is one of the bad debts. That is the

\$33,000 they claim is a contribution to capital. We claim it was nothing other than what we intended to show and what the books indicate it to be and what the evidence will show that it was—a debt owed by this corporation to him—and, consequently, is a legitimate debt. The evidence will show that on and after the 15th day of February, 1945, that corporation was wholly without assets and has never had any business dealings of any kind, and, therefore, there is no intention that it will ever operate.

With respect to the other corporation in which a debt arose, there is the Spencer Dehydrators, Inc. A good deal of the financing for all of the companies and particularly the Spencer Dehydrators, Inc., was conducted through and with the American Business Credit Corporation of Portland. Due to the obligation contained in the financing clause which I mentioned, Mr. Spencer was required to personally sign all of the notes. We will show that the corporations borrowed many hundreds of thousands of dollars and that there were between 150 and 200 promissory notes, which we have here, on which he was required to sign as surety or as joint maker.

It was the understanding between himself and [9] every corporation that he signed for that he was secondarily liable. The funds, we will show, came to the corporations and were used by the corporations for corporate purposes and that as, between the two, he was to be only secondarily liable, although as to the American Business Credit Corporation he stood in the shoes of a joint maker. The Dehydrators, Inc., proved unsuccessful in its operation. During the

first year it lost \$60,000 and during the second year, it lost an additional \$13,000, making a total loss of some \$73,000 during the entire course of its life.

It only ran for two years, and he was obligated to the American Business Credit Corporation, when that liquidation took place, in the sum of about \$46,000 and, at the same time, the Lebanon Corporation, which was the old packing company, and which I am going to refer to now only as the Lebanon Corporation, had been made certain advancements by him, and he paid certain bills for Dehydrators, Inc., on an express guaranty that Mr. Spencer should guarantee all of the account which Dehydrators owed to Lebanon.

Then, there was an overdraft of some \$9,000 that Dehydrators, Inc., owed to a bank in Lebanon, which was also guaranteed by Mr. Spencer.

Then, there were some miscellaneous accounts payable by Dehydrators, Inc., which Mr. Spencer, as an individual, had guaranteed, and those accounts totaled [10] something over, I think \$100,000—I have forgotten the exact figures but, anyway, the assets of the corporation, when it went out of business, were enough to bring this account down to some \$70,000. I believe the assets were in the neighborhood of \$44,000. I have them right here, but I am just trying to outline the facts generally now. He paid those accounts as guarantor, applied the assets and he is claiming the difference as a bad debt owed to him on account of his contract of guaranty. The two amounts together add up to about \$109,000.

Since the fiscal year ended February 28, 1945, the Commodity Credit Corporation and the War Foods Administrator, made an offer on the contract that Dehydrators, Inc., had performed in its last year of operation or during its course of operation, I will say, and the income from that contract accrued was practically accrueable in its last year, February, 1945. The accrued amount on the books show nothing and an auditor from Washington, D. C., came out and found that Dehydrators, Inc., was entitled to some \$12,000 more than the audit showed it was entitled to. We concede in this case, and the pre-trial order admits it, that from the total which we claim from Dehydrators, Incorporated, an additional \$12,000 should be scaled off, and we insist that our net operating loss, carry-back, is \$93,000, and we seek to carry that back to 1943. In 1943, the taxes for that year were forgiven. Any amounts paid that year will of course apply on the 1942 taxes, and, so, we seek to bring this net operating loss carry-back through 1942 to 1943 or for that fiscal year ending February 28, 1944, and have that as a deduction properly taken in the computation for tax for that year, which should result in a refund, if our theory is correct in the case, to Mr. Spencer in the sum of—again, I want to verify the figure—\$74,251.31. That, again, is considerably less than the amount put in the claim which was some \$90,000, due to this adjustment we are speaking of.

That, in brief, is the substance of our claim.

Mr. Garland: If I can be of any help to the Court here, it seems to me it would be along the lines of

testifying. In the first place, most of plaintiff's evidence is immaterial. There are no serious factual questions here involved.

The taxpayer has the burden of showing two things in order to get this carry-back. First, he has got to show that he was, in fact, in the banking business, the financial business. Then, he has to show that the so-called advance to these corporations as a guaranty, or banking arrangements that he had with them, resulted ultimately in bad debts in capital investment, because the Commissioner has determined that they were capital investments, and has allowed capital [12] deductions on that basis.

Counsel neglected to tell your Honor, I think, that Mr. Spencer organized these companies, the two here involved, I believe, the Dehydrators, Inc., and the Yakima Corporation. He was the sole stockholder. There might have been one qualifying share in the name of his son-in-law but, in any event, he was the sole stockholder and president of the company, chairman of the board of directors, and, so, they were his corporations. He formed them in 1943. They were newly formed. Then, he turned over to them certain leases and contracts which did not cost him anything—he got these growers' contracts. He turned these over to these corporations. They were going to can fruit and vegetables. They had no money to operate on, so he went to this American Business Credit Corporation, ABC, for abbreviation, and he arranged with them for financing, and of course they were not going to finance these companies that did not have any assets unless Spencer guaranteed the liability.

Now, he says that he was secondarily liable. Here he owns all the stock. An understanding between himself and the corporation is anything he cares to make it. Now, he had his stock, and everything he put into the corporations was to protect his interest in them and get them going, get them operating, to make money for himself, and for them to take the position that those were loans to the corporations, that they could not get any loans unless he personally guaranteed them is, we believe, something that cannot be supported.

So, as I say, he has got two hurdles. First, he has got to show he is in the financing or banking business. The second is that these were loans to the corporations in order to get the bad debt adjustment, and that they were not capital investments.

These matters of evidence make it look like it is conflicting, but it is not. If your Honor holds and finds that he was in the banking business and that he made actual loans to these corporations, wholly owned and formed for the purpose of taking the loans without security or assets, then, they are entitled to a considerable refund. The facts here as to the amount of income and the amount of obligations paid are not in dispute at all, or, in any event, in a very minor way, so the evidence here should be confined, it seems to me, to the things that are in dispute, so as not to unnecessarily encumber the record.

Mr. Jones: I think that is a good way to get off. I will ask for the admission of our income and expense or profit and loss sheets, evidenced by Exhibits 70, 71 and 72.

Mr. Garland: I have not had a chance to look them [14] over or examine them or to have our auditor look them over or work on them. These are reports made by them. Do these vary from the Revenue Agent's report?

Mr. Jones: If the Court please, may I bring the accountant and attorney who did the work on these up to the table, to have him sit by me during the trial?

The Court: Yes.

Mr. Garland: Do you have any disagreement with the finding of the Commissioner on the question of the obligation? Let us not call them "bad debts," and I won't ask you to call them "capital investments." Do you find any variance between your work sheets and the Revenue Agent's report?

Mr. Jones: Let me explain that. These are brief take-offs from the books of account.

Mr. Garland: I would rather have you answer my question.

Mr. Jones: I want to explain this. These are balance sheets made up from the accounts in the books. They are nothing but a summary of the books, summary taken from the books, a profit and loss statement made up from the books of account.

Mr. Brown: The figures are the same except the \$510.15.

Mr. Garland: Except \$510.15?

Mr. Brown: Yes. [15]

Mr. Garland: We are \$510 apart on this item of obligations.

Mr. Brown: That is on the net income for that year.

Mr. Garland: That is not very far. We will concede that, for the purpose of expediting the trial. The Revenue Agent's report then is satisfactory to you?

Mr. Brown: On the label adjustment, we will agree.

Mr. Garland: The label issue is simply this: I discovered that they had used the label that they started off with here. They said that they had bought them for a certain price and then wrote them off as deductible. Of course, then, I found they had used them.

Mr. Jones: I do not want to make an issue of it at this time. Then, Pre-Trial Exhibit 63 may go in as showing our income for the two years?

Mr. Garland: That is right.

(Document headed "Treasury Department, Internal Revenue Service," dated Seattle, Washington, March 7, 1946, addressed to C. B. Spencer, signed Internal Revenue Agent in charge, enclosing report of examination of income tax returns, thereupon received in evidence and marked Plaintiff's Exhibit No. 63.)

Mr. Jones: How about deductions? [16]

Mr. Garland: Will you take the same course with deductions?

Mr. Jones: Yes, except, of course, if they allow us \$15,273.36 as net operating loss carry-back, we are not conceding that that is correct, because we are claiming it is some \$92,000.

Mr. Garland: Of course, that is shown. I am not asking you to concede that.

Mr. Jones: Then, for the year 1943, the \$25,000 that you want to return to us as excessive profits that we paid less about 90 per cent of the tax on that amount,—that matter is at issue now in the Tax Court.

Mr. Garland: You want us to take those taxes, this tax?

Mr. Jones: We want to report that \$25,000 as income and pay taxes on it.

Mr. Garland: We are not trying a renegotiation case here. Anything that is done, of course, will not be binding on the Court in any case.

Mr. Jones: That goes in as income for us in this case.

Mr. Garland: No. Here is a case where they are trying to give us income.

No judgment can be finally determined in this case on that.

Mr. Jones: That \$25,000 of income brought the tax up [17] into the 90 per cent bracket, or about 95.

Mr. Garland: Any judgment in this case may be reopened to coincide with the final determination of the Board on the renegotiation proposition. That is the only proper way. We do not want to be in a position where the Government is inconsistent, collecting a tax on income while the Board is determining the renegotiation claim.

Mr. Jones: No. I don't agree with you at all. The Board has taken the position that we have earned \$25,000, the amount we are entitled to show

in the year 1943, the year ending February 28, 1943, and they want to give that back. We have already reported that \$25,000 for that year's income. On the \$25,000 we pay approximately \$22,500. There is less than \$3,000 in issue if we lose out in the Tax Court. All we have to do, if they get a judgment against us in the Tax Court to the effect that it was excessive profit, all we have to do is to give the Government a check for \$3,000, and I do not see why a matter pending in that court has a thing to do with this trial under those circumstances, when we have already reported on the 1942 return, that is, the return ending in 1943, the 1943 fiscal year, and have paid the tax on it and they have got the money, and the money is 90 per cent of the item.

Mr. Garland: We do not have the money. It has been determined here and that has been allowed. Why do you say [18] we have got the money?

Mr. Jones: We haven't got the money back.

Mr. Garland: That has been determined, and the amount you paid has been determined. In determining that, we have allowed you twenty-some thousand dollars, so he hasn't paid anything. I do not think this Court wants to make a finding, if it can avoid it, which would operate in that case because, after all, the right to negotiate cannot be tried here properly. It seems to me we ought to take what steps we can to avoid that.

Mr. Jones: Of course, the issue is this, your Honor: If they disallow it, then the Government gets the whole \$25,000. That is the issue. If it is

just normal income, ordinary income, we keep \$2250 of the \$25,000. Mr. Jacob has called my attention to this point, that that is within the exclusive jurisdiction of the Tax Court, to determine whether that is excessive profits or not. If it is, all we have to do is pay an amount that will be less than \$3,000. Of course, you say it is allowed. You have got a piece of paper here, Exhibit 63, that says we can have it back, but we don't want it back. We want it in there as ordinary income.

Mr. Garland: It has been allowed. I do not see how counsel can require the Government to endeavor to collect more taxes on it. [19]

Mr. Jones: We concede, Mr. Garland, that the adjustment that is made for the year ending February 28, 1944, that is, the \$87.62, should be added back into income for income tax purposes, but not for Victory tax purposes. It is not allowable in computing the Victory tax, and certainly should not be added—

Mr. Garland: You can concede what you like. We haven't broken that down in that detail.

Mr. Jones: It is agreed that the \$687.62 refund to Mr. Spencer, plaintiff, from the State of Oregon for State of Oregon income tax should be added into income for the fiscal year ending February 28, 1944, for the purpose of computing income but not Victory tax liability. That leaves only the year 1945, so the adjustment that I am going to next mention should apply to the taxable year ended February 28, 1945.

We concede there that the Agent's report is correct, except \$12,262.82 which we claim we were entitled to for work done by Dehydrators during taxpayer's fiscal year which ended on the date mentioned, should be added to income for that year, decreasing what we consider Dehydrators' bad debts by that amount.

Mr. Winter: Or, according to our position, increasing capital investment.

Mr. Jones: On that position, I think that would be correct. [20] The other item I am sure is in the Agent's report. We concede the amortization item. That establishes, your Honor, I believe, all the income and deductions and adjustments thereto for all the fiscal years involved in this case. Now, I would like to call Mr. Spencer as a witness. First, I want to add to that summary that I made: Except for the inventory item which is a point in controversy, the label inventory.

Mr. Winter: The label inventory adjustment.

Mr. Jones: That is right. [21]

C. B. SPENCER

the plaintiff herein, produced as a witness in his own behalf, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Jones:

Q. Will you state your name in full to the Reporter? A. Cecil Bond Spencer.

(Testimony of C. B. Spencer.)

Q. Your residence?

A. 835 Oak Street, Salem, Oregon.

Q. What business did you follow up until February 28, 1943? A. Canning business.

Q. How long have you been in the canning business? A. Some thirty years.

Q. During that period, did you ever build and own a cannery? A. No, sir.

Q. During that period, did you ever build and own one? A. Up to 1942, yes, sir.

Q. Where? A. In Lebanon.

Q. When was the Lebanon cannery built?

A. In 1935.

Q. Did you operate as an individual?

A. Yes, sir.

Q. From then until when?

A. From then until 1943. [22]

Q. After 1943, who operated it?

A. The Spencer Packing Company of Lebanon.

Q. The Spencer Packing Company of Lebanon, a corporation? A. Yes.

Q. Were you an officer of the Lebanon Corporation? A. Yes, sir.

Q. And a director? A. Yes, sir.

Q. Did you receive any salary from it?

A. No.

Q. I will come back to your corporation in just half a minute. I will ask you if you were an officer and director of the Spencer Packing Company of Yakima? A. Yes, sir.

(Testimony of C. B. Spencer.)

Q. And of the Spencer Dehydrators, Inc.?

A. Yes, sir.

Q. Did you receive salaries from any of those corporations? A. No, sir.

Q. The Lebanon Corporation lease, I want to show it to you.

The Court: You don't need to show him all those leases.

Mr. Winter: We have no objection if you want to introduce 4, 5 and 6 in evidence. We have no objection.

Mr. Jones: I would like to introduce Pre-Trial Exhibits 4, 5 and 6 in evidence. [23]

Mr. Winter: No objection.

The Court: Admitted.

(Lease, dated October 5, 1943, between C. B. Spencer and Grace N. Spencer, and the Spencer Packing Company of Lebanon, was thereupon received in evidence and marked Plaintiff's Exhibit No. 4.)

(Lease, dated October 5, 1943, between C. B. Spencer and Grace N. Spencer and Spencer Packing Company of Yakima, was thereupon received in evidence and marked Plaintiff's Exhibit No. 5.)

(Lease, dated March 31, 1944, between C. B. Spencer and Grace N. Spencer and Spencer Dehydrators, Inc., was thereupon received in evidence and marked Plaintiff's Exhibit No. 6.)

(Testimony of C. B. Spencer.)

Mr. Jones: I would like to hand them to the witness, so he can testify that these are the leases covered in this action.

The Court: Well, they are. There is no issue about that.

Mr. Jones: Very well.

Q. When did you acquire that prune drier in Lebanon?

A. I believe in the fall of 1943. [24]

Q. After you got it, what did you do with it, Mr. Spencer?

A. I converted it into a dehydrator for drying of vegetables.

Q. Did you ever operate that as an individual?

A. No, sir.

Q. After it went into operation, what company operated it?

A. Spencer Dehydrators, Incorporated.

Q. Did you ever lease a cannery in Yakima?

A. Yes, sir.

Q. Did you ever operate that as an individual?

A. Yes, sir.

Q. From when until when?

A. From 1940 until 1943.

Q. While you operated that as an individual, did you acquire any adjoining lands?

A. Yes, sir.

Q. What did you do with them?

A. I built additional buildings on it.

Q. And equipped them for what?

A. Equipped them for a cannery.

(Testimony of C. B. Spencer.)

Q. After March 1, 1943, did you operate that as an individual? A. No, sir.

Q. What did you do with it?

A. I leased it as an individual, leased it to the Spencer Packing Company of Yakima, a corporation.

Q. How long did these corporations continue in business? [25] A. Until liquidated.

Q. Has the Lebanon Corporation been liquidated? A. No, it has not.

Q. Let us put it this way: How long did the Dehydrators and the Yakima Corporation continue to operate?

A. I sold the Yakima operation in 1944.

Q. What part of 1944?

A. Summer of 1944.

Q. Did you do any packing in 1944 at Yakima?

A. No, sir.

Q. The corporation packed only during the 1943 season?

A. That is right. That was the last pack.

Q. During what time did you operate the Dehydrators?

A. Two years, 1943 and 1944, I believe.

Q. I would like to have you state exactly what you did as a corporate officer and director.

A. What I did? What is your question?

Q. What your duties were as an officer and director of these corporations?

A. To arrange for the pack and the sale of it.

(Testimony of C. B. Spencer.)

Q. Did you carry on any business during the time these corporations were operating, you as an individual? A. Yes.

Q. Did you have an individual business?

A. Yes. [26]

Q. Will you explain in detail what that individual business was?

A. Why, I was acquiring property for canneries, and renting, leasing, and financing the operation of them.

Q. Who arranged for the finances for these cannery operations? A. I did.

Q. Did you do that as an individual or as a corporate officer?

A. I had to guarantee them as an individual.

Q. After you once acquired a cannery property, did you have any other duties as the owner of the cannery in keeping it up or enlarging it, anything of that kind?

A. Yes, sir, I had to enlarge them and build additional buildings, buy new equipment, and see that the plants were kept in operating condition.

Q. Can you estimate how much of your time was put into your individual business, as distinguished from that of a corporate officer?

Mr. Garland: Object to the form of the question, your Honor.

Q. (By Mr. Jones): How much time did you put in to acquire cannery properties, in acquiring cannery properties, and all the other things you

(Testimony of C. B. Spencer.)

detailed of that kind, as distinguished from what you put into your duties as a corporate officer and director? [27]

A. I would say one-third of my time.

Q. Have you any idea how many notes you guaranteed in your individual capacity for these corporations? A. Several hundred.

Q. Do you know how much the volume would run to? A. Several hundred thousand dollars.

Q. How frequently were you called upon to pursue these duties or these services that you have referred to as distinguished from your corporate duties?

Mr. Garland: Objected to, your Honor, as leading and suggestive.

The Court: He may answer.

(Question read.)

A. Weekly.

Q. (By Mr. Jones): Did it require you to do any traveling? A. Yes, sir.

Q. Will you explain that?

A. Travel from Portland to Albany, or from Lebanon to Portland, Yakima to Seattle, to Washington, D. C., New York—

Q. During this time, in enlarging these plants, did you have any occasion to have to contact Government bureaus for any purposes?

A. Yes, sir.

Q. What? [28]

A. We had to contact them for priorities, certificates of necessity and contracts.

(Testimony of C. B. Spencer.)

Q. When the Dehydrators was converted from a prune drier into a dehydrating plant, did you obtain any sort of certificate for that?

A. Yes.

Q. What was it?

A. A certificate of necessity.

Mr. Jones: I would like to introduce into evidence Plaintiff's Pre-Trial Exhibit No. 3.

Mr. Garland: I see no materiality. However, that is our only objection.

Mr. Jones: I believe that you are right, since amortization has been admitted. I will withdraw it. That is the only purpose.

Q. How many trips did you have to make back to Washington, D. C., with respect to finally getting the certificate of necessity?

Mr. Garland: Objected to as immaterial.

Mr. Jones: The burden is on me, I think, to show the basis for this, as has been stated by our own Circuit Court of Appeals. I feel like I am bound to assume the burden that they put on me to show.

Mr. Garland: Well, we have made our objection.

Mr. Jones: Very well. [29]

Mr. Winter: And also that he took the president of the corporation with him.

Mr. Jones: I move that last remark be stricken.

Q. How many times did you have to go to Washington, D. C., in order to acquire this certificate of necessity?

(Testimony of C. B. Spencer.)

A. I made several trips to Washington. I don't remember just how many were made to get this certificate of necessity, but I made—I am certain of two or more.

Q. Did you finally acquire a certificate of non-necessity? A. Yes, sir.

Q. Did that require any trip to Washington?

A. No, sir.

Q. Can you recall any other matter or duty that you performed in connection with your ownership of those plants, or any of the three of them, other than as a corporate officer or director—anything you did as owner or lessor?

Mr. Garland: Objected to as immaterial, your Honor.

The Court: He may answer.

A. Financing the operation of the plants?

Q. Yes, that you did as an owner or lessor of the plants?

A. My leases provided that I would—

Mr. Garland: The lease is the best evidence.

The Court: He may answer.

A. My leases provided that I assist in financing the operation of the plants. [30]

Q. (By Mr. Jones): How much time did you devote to the financing of the corporations and securing credit for them?

A. Quite a material part of my time.

Q. Did it necessitate any trips?

A. Yes, many.

(Testimony of C. B. Spencer.)

Q. Between where?

A. Between the plants and the banks.

Q. What was your compensation for all this work that you say you were doing, apart from being a corporate officer? A. Only my rents.

Q. Have you any idea of the volume or the value of the additions that you mentioned which you made to these properties during the time you were renting, in money?

Mr. Garland: Objected to as immaterial. It does not involve anything having to do with this case, no issue in this case.

Mr. Jones: I want to show the number of transactions and the amount of money involved and so on.

Q. Can you tell us the amount or value of the additions you made to these plants?

A. My books would show that, but over a hundred thousand dollars.

Q. Were these additions you are speaking of now made during the time you were renting them to the corporations? A. Yes, sir. [31]

Mr. Jones: I want to introduce at this time Plaintiff's Pre-Trial Exhibit No. 16. Is there any objection to that?

Mr. Garland: No objection.

The Court: Admitted.

(Bundle of warehouse receipts thereupon received in evidence and marked Plaintiff's Exhibit No. 16.)

(Testimony of C. B. Spencer.)

Mr. Winter: Do those include notes that he signed before he organized the corporations?

Mr. Jones: All the notes in Exhibit 16 are notes signed by Mr. Spencer as an individual, joint maker with one of the corporations, in order to secure finances.

Q. In converting this plant from a prune drier to a dehydrator, did you do this at the request of any Government agency? A. Yes.

Q. What one?

A. The War Food Administration.

Q. For what purpose?

A. For dehydrating vegetables for the Government.

Q. Why did you find that operation so unsuccessful?

A. Well, due to inexperienced help, several reasons—inexperienced help; continual change of specifications on the part of the Government; inexperienced inspectors—girls in most cases—and shortage of labor. [32]

Q. This help you mentioned as inexperienced, did you finally get it straightened out?

A. The longer we operated the more experienced they became.

Q. Did you ever get on a basis where you could make a profit, that company? A. Never did.

Q. The contracts that the company performed, from whom did you get those contracts?

A. From the War Food Administration.

Q. Did you ever complete any of the contracts?

A. No.

(Testimony of C. B. Spencer.)

Q. Before you closed, did you have any conversation with a War Food Administration representative? A. Yes.

Q. It was closed with their consent and approval?

A. It was closed on their recommendation, that the operation was too small.

Q. During the operation of the plant at Yakima, did it ever make money? When it was operated by the corporation, did it ever make money?

A. The books would show that.

Q. Do you recall?

A. I don't recall. I don't think it did.

Q. In two or three cases here I have referred to "your operation." Were you, as an individual, personally operating [33] the cannery?

A. No, sir.

Q. The corporations were operating them?

A. That is right.

Q. In securing lines of credit, one of them was mentioned as the ABC. Was it necessary for you to mortgage your various properties to secure those loans? A. Yes.

Mr. Jones: There is one of them here I would like to offer in evidence, Plaintiff's Pre-Trial Exhibit No. 15.

Mr. Garland: No objection. There is no question but that these are obligations given to satisfy these.

Mr. Jones: I want to put them in for another reason. Exhibits 13, 14 and 15 are copies of notes, mortgages and agreements with the ABC?

(Testimony of C. B. Spencer.)

Mr. Garland: There is no objection.

Mr. Jones: No objection to any of them?

Mr. Garland: No.

Mr. Jones: Very well.

(Copy of agreement between C. B. Spencer and wife and Spencer Dehydrators, Inc., dated November 24, 1943, thereupon received in evidence and marked Plaintiff's Exhibit No. 13.)

(Copy of agreement between American Business Credit Corporation [34] and C. B. Spencer and wife and Spencer Dehydrators, Inc., dated November 24, 1943, thereupon received in evidence and marked Plaintiff's Exhibit No. 14.)

(Copy of agreement dated February 10, 1944, between Spencer Packing Company of Yakima, Spencer Packing Company of Lebanon, Spencer Dehydrators, Inc., C. B. Spencer, Grace N. Spencer, and American Business Credit Corporation, thereupon received in evidence and marked Plaintiff's Exhibit No. 15.)

Mr. Jones: The note is No. 12. I want to also include No. 12, your Honor.

Mr. Garland: No objection.

The Court: Admitted.

(Note dated Portland, Oregon, November 24, 1943, signed Spencer Dehydrators, Inc., in amount \$25,000, payable to American Business Credit Corporation, thereupon received in evidence and marked Plaintiff's Exhibit No. 12.)

(Testimony of C. B. Spencer.)

Mr. Winter: I just want to call the attention of the Court to the fact that the note is only signed by the corporation; it is not Mr. Spencer's.

Mr. Jones: No. Exhibits 12, 13 and 14 are notes, [35] mortgages and agreements for the payment of the money while No. 15 is an exhibit I am also offering—I first want to ask this question:

Q. Did you have other notes and mortgages or trust deeds for all the different plants that you made with ABC? A. Yes.

Mr. Jones: This one is a joint agreement between all the companies and Mr. Spencer. I offer it as No. 15. That has been admitted, your Honor.

The Court: Yes. Admitted.

Q. (By Mr. Jones): Did you have any understanding between yourself and the three corporations as to what your responsibility would be as between yourself and the corporations on the notes that you signed?

Mr. Winter: Object to that.

Mr. Garland: That is objected to. The notes are in evidence. They speak for themselves. Any legal liability that might arise between Spencer as an individual and the corporations would appear here, as a matter of law, from the notes.

Mr. Jones: I have a long line of cases that I can cite to the effect that oral testimony is admissible to show that as between two joint makers of a promissory note one of them is primarily and the other secondarily liable.

(Testimony of C. B. Spencer.)

The Court: I have heard that before, I believe, but [36] the fact is he is still a stockholder in these corporations.

Mr. Jones: It is a fact that Mr. Spencer owned a majority of the stock or owned all of the stock but three or four qualifying shares.

The Court: What is the purpose of your question?

Mr. Jones: The purpose of my question is to prove the surety relationship.

The Court: To go on with my question, is this in writing?

Mr. Jones: Not the agreement that I am inquiring about now; that is entirely an oral agreement.

The Court: Whom did he have it with?

Mr. Jones: He had it with the secretary of the corporation.

The Court: All right. Go ahead.

Mr. Winter: That is his son-in-law.

Mr. Jones: That is his son-in-law, yes.

The Court: Ask your question.

(Pending question read.)

A. Yes.

Mr. Garland: That is objected to, if the Court please. To allow the witness, who is in this position of sole stockholder, to give testimony as to an understanding that he had himself, as chairman of the board of directors with his son-in-law definitely opens the door to testimony that is ordinarily excluded. [37]

(Testimony of C. B. Spencer.)

The Court: You may attack its value, of course. He may answer, subject to the objection.

A. Yes.

Q. (By Mr. Jones): Will you state the substance of that understanding?

A. That I personally had to finance the operation and that I was responsible for the bills of the corporation.

Q. The question was as to these notes that you signed. As between you and the corporation, was there any understanding with respect to who would be primarily and who would be secondarily responsible? A. Yes, that was me.

Mr. Garland: We think we are entitled to have the question put in strict form, your Honor.

The Court: He may answer.

A. Yes.

Q. (By Mr. Jones): Would you state what that agreement was?

Mr. Winter: When and where was the agreement made?

The Court: Don't interrupt now. Answer the question. What was the arrangement and understanding?

Q. (By Mr. Jones): What was your understanding?

A. That I was jointly responsible with the corporation.

The Court: He wants to know if you were a surety or principal, as between you and the corporation?

A. I can't say that I understand, your Honor.

(Testimony of C. B. Spencer.)

The Court: Go ahead, Mr. Jones.

Mr. Jones: I will put it this way: Did you have any understanding between yourself and the corporation, for the corporation, whose duty it was in the first instance, to repay the money borrowed?

A. Yes, sir.

Q. Whose duty?

A. Myself, as an individual.

Mr. Garland: The question is answered.

The Court: Let him alone, now.

Q. (By Mr. Jones): I want to ask this: Did you borrow this money for your own use?

A. No, sir.

Q. What use was it borrowed for?

A. For the operation of the business.

Q. Mr. Spencer, out of what fund or out of what income were the notes to be paid?

A. Out of the operation of the business.

Q. Who was operating the business?

A. The corporation.

Q. If the corporation's income could not pay the notes, then you got stuck?

A. That's right.

Q. Was that, in substance, your understanding?

A. Yes. [39]

The Court: Are we going to have the minutes?

Mr. Jones: There are no minutes on that. That is entirely an oral understanding, your Honor.

The Court: Counsel is entitled to have you be specific. He has given you wide leeway to show it in general terms, but he is entitled to have you

(Testimony of C. B. Spencer.)

be specific as to when and where and under what circumstances that arrangement was made.

Mr. Jones: Where did you make these arrangements? A. In the office of the corporation.

Q. And with whom? A. The secretary.

Q. What is his name?

A. Bingham Powell.

Q. And when were these arrangements made?

A. They were made when we found it necessary to finance them that way.

Q. When was it?

A. It was during all the operations of the corporations.

The Court: Who was the secretary?

A. Bingham Powell.

The Court: His relationship?

Q. (By Mr. Jones): His relationship to you?

A. He happens to be my son-in-law.

The Court: Are you going to have the records showing [40] the stock ownership?

Mr. Jones: Well, I will read into the record what they are.

The Court: They are going to be in evidence?

Mr. Jones: Exhibits 59, 60 and 61 are the Articles of Incorporation and they show the subscribers. 98 shares of stock—

The Court: What company are you talking about?

Mr. Jones: This is the Spencer Packing Company of Lebanon and Mr. Spencer owns 98 shares of stock, Mr. Powell one, and C. B. Spencer, Jr., one.

(Testimony of C. B. Spencer.)

The Court: How much did they pay in for the stock?

Mr. Jones: They paid in \$10,000 worth of growers' contracts.

The Court: That was the value put on the contracts?

Mr. Jones: Yes.

The Court: But what I am interested in is that he is entitled to have everything that bears on the relationship of the parties, financial and personal. Did the son-in-law have a financial interest in the company?

Mr. Jones: I am going to put him on the witness stand.

The Court: All right.

Mr. Jones: I have him here to go into that.

The Court: How many witnesses will you have?

Mr. Jones: Three, your Honor. The testimony of all [41] three of them will be substantially the same.

Mr. Garland: Are you going to put these in evidence?

Mr. Jones: Yes. I will offer these in evidence.

Mr. Winter: What are the numbers, for the purpose of the record?

Mr. Jones: 59, 60 and 61.

Q. Did you guarantee any accounts of the Dehydrators, Incorporated, to anybody?

A. Yes.

(Testimony of C. B. Spencer.)

Q. Will you state whose accounts against the Dehydrators, you guaranteed?

A. American Business Credit Corporation—practically all of those with whom we done business; Associated Oil Company—

Q. Associated or Tide Water?

A. Tide Water—Associated—

Mr. Jones: I would like to offer in evidence Plaintiff's Pre-Trial Exhibit No. 17.

Mr. Garland: No objection.

The Court: Admitted.

(Document entitled "Guarantee," dated 3/18/44, signed by Cecil B. Spencer in re guarantee to Tide Water Associated Oil Company, thereupon received in evidence and marked Plaintiff's Exhibit No. 17.) [42]

Q. (By Mr. Jones): What bank was involved?

A. The First National Bank of Lebanon.

Q. What did you guarantee there?

A. I guaranteed an overdraft.

Mr. Jones: I will offer in evidence Plaintiff's Pre-Trial Exhibits 38, 39 and 40.

Mr. Winter: The purpose primarily is to show that he paid the overdraft?

Mr. Jones: Show the overdraft and also that—also show the payment of it, yes.

Mr. Garland: We concede he paid.

Mr. Winter: No question about the amount. It is just encumbering the record unnecessarily.

(Testimony of C. B. Spencer.)

Q. (By Mr. Jones): I want to know if the bank you mentioned is The First National Bank at Lebanon, Oregon? A. Yes, sir.

Q. The overdraft that you mentioned was one between the Dehydrators and the bank?

A. And that bank, yes.

Mr. Jones: I am going to offer the exhibits mentioned; if there is no objection to the fact that he paid the overdraft, I won't bother to offer his check.

Mr. Garland: He paid the overdraft.

Mr. Jones: Very well.

(Bank records of First National Bank of Lebanon, [43] Oregon, account Spencer Dehydrators, Inc., in re overdraft, thereupon received in evidence and marked Plaintiff's Exhibits 38, 39 and 40, respectively.)

Q. (By Mr. Jones): What about the debt of the Lebanon Corporation, the amount that Dehydrators owed the Lebanon Corporation? Was there any guarantee there? A. I guaranteed that.

Q. With whom was that arrangement made?

A. The secretary of the company.

Q. And about when was it made?

A. I don't remember the date.

Q. Approximately?

A. At the start of the operation.

Q. Give the substance of it. Whom did you make it with? Whom did you take it up with?

A. With the secretary of the company, Birmingham Powell.

(Testimony of C. B. Spencer.)

Q. Give the substance of the conversation?

A. That I would personally be responsible for the operation, if the operation were not in itself successful.

Q. The Lebanon Corporatioan was the older of the corporations? A. Yes, sir.

Q. Or the older plant, I should say?

A. Yes.

Q. Was there any plan by which any corporation more or less [44] acted as banker to the others?

A. Yes. The Lebanon plant—everything was handled out of the Lebanon plant. That was our main office.

Q. The idea of handling it that way—was that ever discussed with any officer of the corporation?

A. Yes, with the secretary.

Q. If the Lebanon plant was in the possession of more money at a given time than another plant, what would it do with it?

A. It would advance money to the other plants.

Q. Was that part of this same arrangement?

A. Yes.

Q. Made at the time you have been talking about? A. Yes, sir.

Q. Was there any reason that you can state why you went into this guarantee arrangement and so forth?

A. Because the banks hesitated to advance the operation without my personal guarantee.

(Testimony of C. B. Spencer.)

Q. Was there any obligation between you and the corporations?

A. Yes, upon the execution of the leases of these plants to the corporations, I agreed to assist in financing where necessary.

Q. Is that the reason for making these agreements? A. Yes.

Q. Is there any clause in the leases to that effect? A. Yes. [45]

The Court: Are you going to have Mr. Spencer's personal worth in the record?

Mr. Jones: Have what?

The Court: Are you going to have his personal financial statement in the record?

Mr. Jones: I had not planned to.

The Court: Isn't that an important background?

Mr. Jones: I will see.

The Court: You think about it.

Mr. Jones: I will see that it is in before the case is closed.

The Court: Do whatever you want to about it.

Mr. Jones: My attention is called to the fact that his personal ledger and journal for those years, Pre-Trial Exhibit No. 29, will show that, and I will offer them in evidence.

The Court: Admitted.

(Personal ledger and journal of C. B. Spencer was thereupon received in evidence and marked Plaintiff's Exhibit No. 29.)

The Court: Recess until 1:30. [46]

(Court reconvened at 2:00 o'clock p.m., December 17, 1946.)

Mr. Jones: If the Court please, I have the cashier from the bank in Lebanon whom I asked to come in last night. He drove up this morning. I only have two or three questions to ask him. I would like to call him—maybe more than two or three. I have a few questions to ask him. I would like to put him on out of order, if I may.

The Court: Yes.

J. H. IRVINE

was thereupon produced as a witness on behalf of the plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Jones:

Q. Will you give your name to the Reporter?

A. J. H. Irvine.

Q. Where is your residence? A. Lebanon.

Q. What is your occupation?

A. I am cashier of The First National Bank.

Q. How long have you been employed by that bank? A. Since 1933.

Q. How long have you been cashier?

A. Since 1933. [47]

Q. Do you know Mr. Spencer? A. Yes.

Q. How long have you known Mr. Spencer?

A. I think it was in 1935 when he first came to Lebanon.

(Testimony of J. H. Irvine.)

Q. That is Mr. C. B. Spencer, sitting here in court? A. Yes.

Q. Did he have an account with your bank?

A. Yes, sir.

Q. Did the Dehydrators, Inc., have an account with your bank?

A. Spencer Dehydrators, yes.

Q. Spencer Dehydrators, Inc.? A. Yes.

Q. Did they have an account there?

A. Yes.

Q. Do you know of your own knowledge whether or not Mr. Spencer ever guaranteed that account?

A. We had a general—

Q. Answer Yes or No, please. Do you know?

A. Yes.

Q. Was it in writing or not? A. No.

Q. Why was it not in writing?

A. Our experience had been with Mr. Spencer, since he first came, that we did not feel it was necessary. We had [48] occasion to loan him money numerous times in connection with his operations and he had always met those obligations as he agreed to do.

Q. Will you state the substance of this guarantee? First, I would like to have you look at Pre-Trial Exhibit No. 38.

Mr. Garland: We have conceded the account was guaranteed and that he paid the overdraft. Is that what you had in mind? It seems it would serve no useful purpose, in view of our concession.

(Testimony of J. H. Irvine.)

Mr. Jones: All right. The account was guaranteed, is that right? A. Yes.

Mr. Jones: That is all.

Mr. Garland: No questions.

(Witness excused.) [49]

C. B. SPENCER

the plaintiff herein, having been previously duly sworn, resumed the stand and further testified as follows:

Direct Examination (Continued)

By Mr. Jones:

I should like to put in evidence Plaintiff's Pre-Trial Exhibit No. 21, which is a certificate of non-necessity. I am not going to bother about putting in the Treasury's granting of the amortization, because you admitted the amortization, but I want this in.

Mr. Garland: No objection.

The Court: Admitted.

(Document entitled "Non-Necessity Certificate," dated May 2, 1945, War Production Board, thereupon received in evidence and marked Plaintiff's Exhibit No. 21.)

Q. (By Mr. Jones): Can you tell me, please, when the Dehydrator Corporation ceased its operations? A. I believe in February, 1945.

(Testimony of C. B. Spencer.)

Q. Along the first of the year?

A. That is right.

Q. What was the plan of liquidating these companies when you got through with them? How were you going to handle the [50] bills that they owed and so forth?

A. Use the money that was obtained by the corporation to pay the bills.

Q. By "money" you mean the accounts receivable and things of that kind?

A. That is right.

Q. Assets?

A. Yes, or any sales that could be made to liquidate the equipment and so forth, to apply on the liquidating of that indebtedness.

Q. That applied to Yakima and Dehydrators?

A. That is right.

Q. Do you know at this time of any asset or any uncompleted contract or any sum or any property of any kind owned by either Yakima or Dehydrators that has not been accounted for in your books? A. No, sir.

Q. Will you explain the circumstances that led up to the closing of the Yakima plant?

A. It became so hard to do business. We had an extreme shortage of labor. Prices were high on the raw products. Our sales prices for the finished products were governed by OPA on an historical background which made it impossible to operate the business at a profit.

(Testimony of C. B. Spencer.)

Q. On what basis are your books kept? [51]

A. On an accrual basis.

Q. Who was in charge of keeping the books?

A. Bingham Powell.

Q. And he is your son-in-law? A. Right.

Q. Now, then, if a charge or a credit that should go into those books originated with you, what did you do about it?

A. I would discuss it with him.

Q. And it would be his duty then to do what?

A. To put it where it belonged.

Q. Are you familiar with the details of your own records or the records of these corporations?

A. No, sir.

Q. Did you pay all the balances that were owed by Dehydrators? A. Yes, sir.

Q. Now, then, the assets taken over by Yakima, how were they applied? On what bills were they applied, do you know?

A. They were applied against the bills of the Yakima Corporation.

Q. Did you have a bill against it?

A. I had a bill against it.

Q. Whatever that was, it was partially applied against that? A. Yes.

Q. The balances that show on your books—I will connect this up later with certain exhibits I am going to offer. [52]

(Testimony of C. B. Spencer.)

The balances that are true balances, as your books indicate, and which we are claiming in this case are bills—have those balances ever been paid to you, other than the application of some \$12,000?

A. No, sir.

Q. No part of it? A. No, sir.

Q. Have you in any way ever released those bills to the corporation? A. No, sir.

Q. Have the corporations been formally dissolved? Do you know the answer to that?

A. I don't know.

Q. I want to call your attention to Pre-Trial Exhibit No. 25, which I am going to offer in evidence. That is the Lebanon Corporation, the canning company. The payment of these bills is a part of the means by which another debt was paid?

Mr. Garland: A debt involved in this case?

Mr. Jones: Yes. \$53,000 owed by Dehydrators to Lebanon Corporation was charged to Mr. Spencer and it went into his general account between him and Lebanon and, when he was balancing off his account with Lebanon, he took over and personally paid these bills, so, no matter how you apply the payments, everything in it was paid? [53]

Mr. Garland: No objection.

Mr. Jones: I am offering in evidence Plaintiff's Pre-Trial Exhibit No. 25.

The Court: Admitted.

(Group of notes executed by Spencer Packing Company of Lebanon, marked "Paid,"

(Testimony of C. B. Spencer.)

thereupon received in evidence and marked Plaintiff's Exhibit No. 25.)

Mr. Jones: I think the witness should see these.

(Plaintiff's Exhibit No. 25 handed to the witness.)

A. These have been paid.

Q. They have been paid? A. Yes, sir.

Q. By you, personally? A. Yes, sir.

Q. Do you know of any credit of any kind due either Dehydrators, Incorporated, or Yakima Corporation that have not been entered into your books and given to you? A. I know of none.

Q. The capital stock of these corporations, as shown by exhibits in evidence, were growers' accounts, and I want to call your attention to Plaintiff's Pre-Trial Exhibit No. 62.

Mr. Winter: You don't mean capital stock. That was [54] turned in by Spencer personally, not by any of the other incorporators.

Mr. Jones: Mr. Spencer turned in all of them, that is right.

Mr. Winter: The other incorporators did not turn them in?

Mr. Jones: No.

Mr. Garland: What is the purpose of that?

Mr. Jones: Just to show the form that the growers' accounts were made out in. I am going to ask about it.

Q. Plaintiff's Pre-Trial Exhibit No. 62, can you see it from there? A. Yes.

(Testimony of C. B. Spencer.)

Q. Do you know what it is?

A. Standard fruit and vegetable contract.

Q. Is that the form on which all growers' contracts which were issued in payment of the capital stock of all three corporations were made out on?

A. Yes, sir.

Q. The capital stock of the Lebanon Corporation you stated as \$10,000, according to the minutes here in evidence. Do you know what the value of the growers' contracts were that were turned in for that stock?

Mr. Winter: Objected to as incompetent, irrelevant and immaterial. There might be some materiality if there is any [55] testimony as to the cost, but whatever this witness may have considered as the cost is immaterial.

The Court: Answer yes or no. Do you know the value? A. Yes, sir.

Q. (By Mr. Jones): Go ahead and tell what the value was. A. The value—

Mr. Winter: Object to that. Did your Honor rule?

The Court: Go ahead.

A. The value is usually considered \$5 a ton buying charge.

Q. (By Mr. Jones): How are those contracts acquired?

A. By going out and contacting the various growers and signing contracts with them.

Q. Have you any independent recollection at this time of approximately how many of them were turned over to the Lebanon Corporation? I will

(Testimony of C. B. Spencer.)

see if this recites it. If it does, it is probably the best evidence. It says 600 of these contracts were turned over for the capital stock of Lebanon. Were those 600 contracts acquired in the manner you have just stated? A. Yes.

Q. Could a new corporation or a new cannery go into business without them?

A. Absolutely not.

Q. Why?

A. They must have the raw products on which to work. [56]

Q. What does that do?

A. That furnishes them with a supply.

Q. Do you know what the value of these would have been to the Lebanon Corporation at the time they were turned over to it for its stock?

Mr. Garland: The Lebanon Corporation is only indirectly, if at all, connected. You are talking about the Lebanon now?

Mr. Jones: That is right.

Mr. Garland: What difference does it make?

Mr. Jones: I will take it up as to the other corporations. I was going to do it with all three. I think you are probably technically right on that point.

On the Yakima Corporation, we will see if it states how many there were. It says there were approximately 600 there.

Do you know what the value of the 600 growers' contracts to the Yakima Corporation would have been at the time they were turned over to it?

(Testimony of C. B. Spencer.)

A. They would have been in considerable excess of \$10,000.

Mr. Winter: All of them say approximately 600?

Mr. Jones: No, I don't think the other one says anything. The Dehydrators, Inc., says "a number of contracts."

Q. Do you have any independent recollection at this time of the contracts that were turned over to Dehydrators in exchange for its capital stock of \$5,000? [57]

A. Processed three different vegetables, beets, carrots and potatoes, and there were, I should judge, in all, some 50 to 100 different contracts.

Q. Do you have any idea what the value of those contracts was to the corporation at the time you turned them over?

A. In excess of the \$5,000.

Q. How long did these contracts run by their terms? A. They ran for that current season.

Q. Do they have any value after the season is over? A. No, sir.

Q. There has been some statement here about inventories of labels in connection with the operation that you ran as an individual in 1942; you ended that year, February 28, 1943, with some label inventory. Do you know the details of what happened to those inventories?

A. Those inventories were written off.

(Testimony of C. B. Spencer.)

Q. And, then, were they subsequently used?

A. They were, due to the extreme shortage of paper, and we had been unable to get labels. We have in every way attempted to use those labels by reprinting, blocking out and otherwise making them as presentable as possible to use.

Mr. Garland: We submit he is not answering the question. I submit his answer is not responsive.

Q. (By Mr. Jones): Have you used all of them yet? [58] A. Nowhere near all of them.

Q. Those that you have used, did you have them reprinted as you have said? A. Yes.

Q. At an extra cost and expense to yourself?

A. As much as the original cost.

Q. At the end of the year, on February 28, 1943, were they considered of any value to you?

A. No, sir. I might qualify that a little further. A great many of the sizes that we were using were outlawed by the Government restriction of canning sizes, and they are still.

Q. Did you ever at any time contribute or intend to contribute any capital to any of these corporations, other than the growers' contracts?

A. No, sir.

Mr. Jones: I should like at this time to introduce in evidence Plaintiff's Pre-Trial Exhibits 26, 27 and 28, for the years ending 1943, 1944 and 1945. They are the tax returns I asked from you.

Mr. Garland: We will have them for you here. Just offer them.

(Testimony of C. B. Spencer.)

Mr. Jones: I offer those in evidence, and also would like at this time to offer in evidence the claim of which you have a photostatic copy.

Mr. Garland: We will produce it. That will be substituted [59] for Pre-Trial Exhibit No. 1.

Mr. Jones: We will have it marked.

Mr. Garland: No objection.

(Photostatic copy of claim for refund of \$93,565.04, Federal Income Tax for the Fiscal Year Ended February 28, 1943, thereupon received in evidence and marked Plaintiff's Exhibit No. 1.)

(Certified copy of Amended Individual Income Tax Return, February 28, 1943, filed by C. B. Spencer, thereupon received in evidence and marked Plaintiff's Exhibit No. 26.)

(Certified copy of Individual Income Tax Return, February 29, 1944, filed by C. B. Spencer and Grace N. Spencer, thereupon received in evidence and marked Plaintiff's Exhibit No. 27.)

(Certified copy of Individual Income Tax Return, April 25, 1945, C. B. Spencer, thereupon received in evidence and marked Plaintiff's Exhibit No. 28.)

Mr. Jones: There are some tax returns for prior years that I want to refer to and I believe those are the ones that you said at the pre-trial that you had no objection [60] to presenting.

(Testimony of C. B. Spencer.)

Mr. Winter: I said I would secure them. What returns do you want?

Mr. Jones: From 1937 to and including 1941.

Mr. Winter: 1937, 1938 and 1939, C. B. Spencer?

Mr. Jones: And 1940 and 1941.

Mr. Winter: I have got 1937 through 1940, inclusive.

Mr. Jones: Have you got 1941?

Mr. Winter: No, we do not have it.

Mr. Jones: May I go ahead and put in 1941, the one that is missing, in evidence?

Mr. Garland: We would like to make inquiry of the purpose of these earlier returns. What is the purpose of putting those in?

Mr. Jones: Well, we want to show his income in past years in connection with the argument in the case.

Mr. Garland: Objected to on the ground it is incompetent, irrelevant and immaterial. I don't know what argument he is going to make, but we cannot see how going back four, five or six or eight years has anything to do with any issue here at all.

Mr. Jones: This may be a little premature at this time, that part of the case, but it also does show inconsistent treatment of inventory and for that reason I think it is admissible in the case, your Honor. [61]

Mr. Winter: I do not understand we have any question of inventories in this case.

Mr. Jones: The label inventory.

(Testimony of C. B. Spencer.)

Mr. Winter: Certainly, these returns do not go to this label inventory.

Mr. Jones: If we show we treated it consistently, year after year, charging labels to expense—

Mr. Garland: We will agree they were charged to expense. There is no use cluttering up the record.

Mr. Jones: All right. I want that later in connection with your case in chief. You may cross-examine.

Cross-Examination

By Mr. Garland:

Q. What is your full name?

A. Cecil Bond Spencer.

Q. Mr. Spencer, when did it occur to you to look upon yourself as a financier of corporations? When did it cross your mind that you were in that business?

A. In 1943.

Q. When did you first show your business as that of financing corporations on your income tax returns?

Mr. Jones: I think that is irrelevant.

Mr. Garland: All right.

A. I would have to leave that to my tax attorney.

Q. (By Mr. Garland): When were you first advised to make [62] them out that way, to show that you were in the business of financing corporations?

A. Well—

Mr. Jones: There is no evidence that he has been advised.

(Testimony of C. B. Spencer.)

Mr. Garland: This is cross-examination, if the Court please. I can lead him on cross-examination, I believe, and cross-examine him generally on the proposition here presented and the issues.

(Pending question read.)

A. Those matters were handled by my tax attorney.

Q. (By Mr. Garland): Did you ever show on your return that you were in the business of financing corporations?

A. I would have to leave that to my attorney to answer.

Q. In other words, if it was proper to make that declaration, you left it to your tax accountants to put it in, is that right? Is that right?

A. I left those matters all to my tax attorney.

Q. I show you your income tax return for the fiscal year ended February 29, 1944, and call your attention particularly to Schedule C-2, and ask you to read what it shows there concerning the nature of your business.

A. Where do you find that?

Q. Schedule C-2. What do you show as your business?

A. Business name "Spencer Packing Company." [63]

Q. What do you show with regard to the nature of your business, if anything?

A. There is nothing that is to indicate it.

(Testimony of C. B. Spencer.)

Q. There is an indication there that something has been erased. Do you have any recollection concerning that? A. No, sir.

Q. Is there an indication it has been erased?

A. I couldn't state.

Q. You are looking at the paper which has been erased. Do you know anything about that?

A. No, sir.

Q. I will show you your income tax return for the next fiscal year, the fiscal year ended February 28, 1945. There, you are stating your occupation for the first time. What do you show there?

A. Food processing plant, rentals, operation and financing.

Q. That is the year of these carry-back leases, isn't it, 1945? That is the leases you want to carry back? A. That is right.

Q. Did your tax counsel tell you at that time in order to carry it back and in order to be in a position to make that argument, you would have to put that in there?

A. I had nothing to do with it, sir.

Q. What companies have you assisted in their financial structure, or their financing, in which you did not own stock? [64]

A. Would you state that again?

(Pending question read.)

A. None.

Q. Then, you have never financed any corporation that you did not own all of the stock except qualifying shares? A. For this purpose, yes.

(Testimony of C. B. Spencer.)

Q. What is your answer? Is your answer qualified? A. No.

Q. What was your answer?

A. I have not financed any other operations.

Q. You owned all the stock except a qualifying share in your son-in-law in both the Dehydrators, Incorporated, and the Yakima Canning Company, is that right? A. No, that is not correct.

Q. Who owned the stock, first, of Dehydrators, Incorporated?

A. The Dehydrators' stock was owned by myself, Bingham Powell and C. B. Spencer, Jr.

Q. How many shares of the stock of the Dehydrators, Incorporated, did you have in the beginning and throughout all times until its liquidation? How many shares did you have in that corporation?

A. I had, I think, all of them but two.

Q. All of them but two? A. Yes.

Q. The two you did not have were in the names of your [65] son-in-law and your son?

A. Yes.

Q. They were qualifying shares in order to enable them to be directors, is that right?

A. That is right.

Q. The same applies to the Yakima Corporation? A. No, sir.

Q. Tell us about that one.

A. I owned the majority of the stock in the Yakima Corporation.

Q. How many shares did you own?

A. Probably 98.

(Testimony of C. B. Spencer.)

Q. Who owned the other two?

A. Fred Briggs and Fred Tesch.

Q. How many shares each did they have?

A. And Bingham Powell, three. They had a share apiece.

Q. How many shares outstanding, 100?

A. 100 shares.

Q. You owned 97 shares? A. Yes.

Q. And they owned one apiece for qualifying shares? A. I believe that is correct.

Q. You were President of Dehydrators, Incorporated? A. Yes, sir.

Q. Your son-in-law was the secretary? [66]

A. Secretary-Treasurer.

Q. What other officers did you have?

A. Vice-President.

Q. Who was that? A. My son.

Q. Who was vice-president? A. My son.

Q. How old was he then, in 1943?

A. Oh, in '43 and '18—he would be about twenty-five.

Q. So, the officers of Dehydrators, Incorporated, were comprised of yourself, your son and your son-in-law? A. Correct.

Q. Who were the directors? A. The same.

Q. You were the chairman of the directors?

A. I was president.

Q. Who were the officers in the Yakima plant?

A. I was president, Bingham Powell was—I believe the records will show.

(Testimony of C. B. Spencer.)

Q. You know who they were.

A. That has been several years ago. I think you had better rely on the records.

Q. Don't you know who the officers of the Yakima Corporation were?

A. I know who the officers were, yes. [67]

Q. Who were they?

A. They were Fred Briggs, Fred Tesch, Bingham Powell and myself.

Q. Who were the directors

A. The same.

Q. And you were the president? A. Yes.

Q. You testified, Mr. Spencer, that you spent approximately a third of your time on business which was not connected with the management of your canneries and dehydrator plant?

A. That's right.

Q. You mean that was not connected with the canneries and the dehydrator plant or connected with the management thereof. What financing did you do in that third of your time that you served during this period as an officer and director of those companies? What did you do?

A. What did I do?

Q. Yes.

A. Well, I arranged financing for the operations.

Q. Isn't that what the president and vice-president and 100 per cent stockholder, so to speak, would do in any corporation that needed financing?

A. That is what they might attempt to do.

(Testimony of C. B. Spencer.)

Q. Would their efforts be directed in that course, to that end, if the corporation needed financial help? [68] A. Correct.

Q. How do you say then, Mr. Spencer, that on the one hand your efforts were directed to an enterprise unassociated with your presence and your management of these canneries, in the direction of financing the companies? Explain how that could be.

A. That was part of the provisions in the leases of these plants to the corporations.

Q. You mean, in the leases you agreed and guaranteed the obligations?

A. No, sir, I agreed to assist in financing.

Q. What was done after the companies were set up? What did you do in that direction, other than merely drawing on the bank, on the ABC?

A. I will answer that in this way: We could not get finances to operate the corporations and, in order to obtain finances, I had to mortgage my personal property in order to secure them.

Q. You owned the corporations, didn't you? You owned all the stock?

A. That is a different identity.

Q. Was it your duty to finance them in order to protect your stock?

A. That was a different person; that was a corporation.

Q. But you owned the stock in the corporations? [69] A. Yes.

(Testimony of C. B. Spencer.)

Q. And you wanted the corporations to be a success so that you would enjoy that success as a stockholder, isn't that true? A. Correct.

Q. And, in order to do that, you had to arrange financing for them? A. Not as a stockholder.

Q. They could not have operated if you had not raised finances for them, could they?

A. That is right.

Q. Your stock would have been worthless?

A. Yes.

Q. So, you did it to protect your stock?

A. That was a part of the provisions of the lease, that I was to do that as an individual.

Q. A part of the provisions of the lease?

A. That is true.

Q. You wanted this company to be a success. You were the sole stockholder? A. No, sir.

Q. You did not want it to be a success?

A. I wanted it to be a success, but I was not the sole stockholder, sir.

Q. You say you were not the sole stockholder?

A. That is right.

Q. That is a question. What you did was to expand your credit and invest that money to make the enterprise work, isn't that so?

A. That is correct.

Q. You wanted it to work because it would be money in your pocket if it did work, isn't that so?

A. That is right.

(Testimony of C. B. Spencer.)

Q. If it did not work, they could not pay you the lease money and you would get no other return from the corporation, isn't that so?

A. That is correct.

Q. And, in order for all that to happen, it had to be financed? A. That is right.

Q. So, you arranged for that to take place?

A. I agreed to do that in the lease, when I leased it.

Q. You did that for that purpose?

A. I agreed to do that when I leased the properties to the operating companies.

Q. What was the term of the lease? When did it expire? Did it have any expiration date, do you know? A. I don't remember.

Q. So, you finally decided that it was not a profitable enterprise, either from your standpoint as a stockholder [71] or receiving rentals, isn't that so? A. Yes.

Q. So, when that happened, you closed up?

A. I sold out.

Q. What was your net worth on March 1, 1943, do you know?

A. I don't know. You will have to ask my accountants.

Q. Were you in a financial position to operate these canneries independent of the corporations, or to finance the corporations yourself?

A. The records will indicate that.

Q. Can't you answer that question?

A. Apparently so. All corporations were operating.

(Testimony of C. B. Spencer.)

Q. But they were operating on an agreement with the banker, were they not, which you guaranteed? A. Yes.

Q. You had not the money to operate them independent of the banker? A. No.

Q. You were not in a position to finance these companies, is that right?

A. Not independently, sir. I don't know of anyone who is.

Q. When you organized these companies, you knew you had to raise money for them one way or another in order that they might even get started?

A. I knew money must be secured to operate them. [72]

Q. So, you extended your credit for that purpose?

A. That was the arrangement at the time. It was not necessary if the corporations could secure it otherwise.

Q. How could they secure it otherwise?

A. Well, if the banks would advance the corporations the money.

Q. Didn't the corporations have independent credit enough to go to a bank to get money to start operating? A. That has been done.

Q. Could it have been done in these cases, in connection with these corporations?

A. It was not done in this case, no.

Q. Could it have been done?

A. It was not possible. We exhausted every source.

(Testimony of C. B. Spencer.)

Q. They did not have assets for that purpose when they were incorporated?

A. That is right.

Q. So the only way in the world they could get started was for you to assist them in the financing of it? A. It so appears.

Q. That is right. You knew that when you organized them, didn't you? A. No, sir.

Q. Do you mean to say that when you organized these corporations you thought the corporations could go out and get credit [73] on their own?

A. Yes.

Q. You thought that? A. Yes.

Q. Why was there any occasion for you to guarantee their accounts?

A. Simply as a guarantee that I would assist them.

Q. What reason did you have to think the bank would loan you enough money to get started in these canneries on these growers' contracts?

A. I don't believe that is—how did I start the original business?

Q. I am sure I don't know.

A. This is the same deal.

Q. What do you mean, the same deal?

A. I started the original plant in Lebanon on the same basis.

Q. What basis? A. No financing.

(Testimony of C. B. Spencer.)

Q. No financing? My question was: Did you expect these corporations to finance themselves on the strength of these growers' contracts? That is all they had when they started?

A. That is right.

Q. You knew you had to finance them?

A. I was not positive, no. I built up one business on that [74] basis.

Q. When the Yakima Corporation liquidated in 1945, all the obligations there were yours, were they not? All the obligations of the company were held by you, is that so? A. No, that wasn't so.

Q. Well, who held them?

A. Various creditors.

Q. To what extent? Who is one of them?

A. I was.

Q. To what extent?

A. Oh, the books will indicate.

Q. Do you recall? A. I do not.

Q. Isn't it correct that you paid \$78,864.74 of the obligations yourself?

A. That is probably so. The books will tell that. I don't remember those figures, though, sir.

Mr. Garland: Give him the books. Let him testify from it.

A. I am not familiar with the books, sir.

Q. Would you say that figure is approximate?

A. I believe that is the figure.

(Testimony of C. B. Spencer.)

Q. There were miscellaneous headings in your books called "Miscellaneous Accounts" that you held, \$30.22. Do you intend to leave the impression here with the Court that you [75] did not hold these obligations of the Yakima Company when it was obligated? You had reference to the \$30.22, is that right?

A. Apparently so.

Q. You apparently did. That was the Yakima Corporation we were talking about. What about the Dehydrators, Incorporated? When they liquidated, is it true you held \$45,635.41 of the obligations?

A. The books will indicate that.

Q. Would you say that is approximately correct?

A. If that is on the report, that is true.

Q. American Business Credit held \$46,567.17 and Miscellaneous \$4,786.73, so all except \$30.22 of the obligations of the Yakima Corporation were yours? You held them? Most of that was accrued rental, was it not, unpaid rent?

A. I assume that is correct.

Q. As to the obligations of Dehydrators, Incorporated, in that period, that was mostly unpaid rent, is that right?

A. I would not say that is true, no.

Q. Do you know anything to the contrary?

A. I think a good share of it was lost in the operation.

Q. Is that reflected in the ABC account?

A. I wouldn't know. That is handled by my accountants.

(Testimony of C. B. Spencer.)

Q. In other words, you had two corporations, you knew that, that liquidated their obligations, most of which were yours. [76] You not only owned all the stock; you were manager and president and director; yet, you say you loaned money to these corporations and you are not in the canning business—you are in the financing business, is that what you say? A. That is right.

Q. You made that contention for tax purposes for the first time when it became an advantage to do so, that is right, isn't it?

A. I left that to my tax accountants.

Q. Do you know Alice Berry?

Mr. Jones: If the Court please, that is objected to.

The Court: That question is proper.

Q. (By Mr. Garland): Do you know Alice Berry, also known as Alice Berry Spencer?

A. I claim immunity against self-incrimination.

Q. Would it be incriminating to know her?

Mr. Garland: If your Honor please, I think we are entitled to have that answered.

The Court: No use going any further. He is granted the privilege.

Q. (By Mr. Garland): Do you know Harold G. Bauer? A. Yes, sir.

Q. Did you get him started in business?

A. I assisted him.

Q. Is he still your selling agent? [77]

A. No, sir.

(Testimony of C. B. Spencer.)

Q. At any time, was he your selling agent?

A. He was.

Q. Didn't he handle substantially all the produce and sales—

Mr. Jones: At this point, may the witness be considered a witness for the Government?

Mr. Garland: Yes, we will consider him our witness, if the Court please, under Rule 43(b), Rules of Civil Procedure, which gives the power to cross-examine him, since he is a part to this litigation. If we are out of order and your Honor would rather wait until after the plaintiff rests, we would be glad to do that, your Honor.

Mr. Jones: I don't care what order you take.

Mr. Garland: Are you familiar with that rule?

Mr. Jones: Yes, but he is your witness; that is all.

Mr. Garland: Under that rule, yes.

Q. You paid him commissions for the sale of your canned goods? A. Correct.

Q. During all the period here involved. When did you start?

A. When did we begin with Harold Bauer, you mean?

Q. That is right.

A. We started doing business in 1941. [78]

Q. And you continued until now? You have continued until now? A. Yes, sir.

Q. Do you have that arrangement at present? That arrangement is current? A. Yes, sir.

(Testimony of C. B. Spencer.)

Q. Do you have any idea of the commissions you paid or your company paid Mr. Bauer during your fiscal year 1943?

A. Five per cent of sales.

Q. Five per cent on all sales?

A. Yes. What year did you state?

Q. What is that?

A. What year did you state?

Q. Well, your fiscal year 1943?

A. That is right.

Q. The same thing in 1944?

A. That is right.

Q. And 1945?

A. 1941—what I was getting at, in 1941 he did not handle the entire sales.

Q. He started handling the entire sales in 1942, is that right? A. That is right.

Q. And since then, and through 1945, he handled the entire sales? [79]

A. In a satisfactory manner, yes.

Q. Do your records here reflect the amount of commissions paid to Mr. Bauer?

A. I believe they will show the amount of brokerage paid.

Q. Do you know the amount of commissions during that time? A. No, sir.

Q. Have you any idea? A. No, sir.

Q. How did you happen to select Mr. Bauer to handle your accounts?

(Testimony of C. B. Spencer.)

A. Because I thought he was a bright, capable young man and his past performance in working for other people demonstrated to me he would be a good man to work on his own.

Q. Is it not true that you required him to turn over a certain amount, namely 10 per cent of the amount of his commissions, received from the sale of products you manufactured to Alice Berry Spencer?

A. I had nothing to do with it, sir. I had nothing to do with the operation of his business.

Q. Isn't it true that you made known to him that was a necessary requisite for him to get your business? Isn't that true?

A. Yes, that was the agreement with him, when he formed this company, this sales organization, that he would give [80] her a substantial interest in the business.

Q. Why did he do that, do you know?

A. In order for him to start in business.

Q. In order for him to get your account, isn't that right? A. That is right.

Q. Why were you interested in Alice Berry Spencer receiving that amount of money?

The Court: Don't ask any more of those questions. The man is entitled to privilege.

Mr. Garland: If the Court please, we have got to prove this case.

The Court: You can't prove it by him.

(Testimony of C. B. Spencer.)

Mr. Garland: We cannot prove it by him, that is true. However, I want some advice as to how far your Honor's ruling goes. Do I understand we are not to question him—

The Court: You cannot convict any man under American and English law on his own testimony, or anything that is degrading to him, or that bears on the commission of a crime. You know that and Mr. Winter knows it. There is no need to play around with that question. I won't have it. You have got to prove your point some other way.

Mr. Garland: I am merely endeavoring to ascertain how far the ruling went.

The Court: It is self-evident that it goes to anything that leads to that point. [81]

Mr. Garland: That is all.

Mr. Jones: There is one thing before the witness leaves the stand, that of putting into evidence these contracts that refer to the ABC. I am offering them in evidence.

Mr. Winter: What are the numbers on them?

The Court: Step down.

Mr. Garland: May I make this observation? We make no objection to 8, 9 and 10, except the way in which they are designated here as "Accounts Receivable." We want it understood we will not be affected by the designation.

Mr. Jones: No.

Mr. Garland: There is no significance in the way they are designated?

Mr. Jones: No, not at all.

(Testimony of C. B. Spencer.)

The Court: Admitted.

Mr. Jones: We would like to have No. 7 included.

(Copy of contract dated October 4, 1943, between Spencer Packing Company of Lebanon and American Business Credit Corporation thereupon received in evidence and marked Plaintiff's Exhibit No. 7.)

(Copy of contract dated October 4, 1943, between Spencer Packing Company of [82] Lebanon and American Business Credit Corporation, thereupon received in evidence and marked Plaintiff's Exhibit No. 8.)

(Copy of contract dated November 23, 1943, between Spencer Dehydrators, Inc., and American Business Credit Corporation, thereupon received in evidence and marked Plaintiff's Exhibit No. 9.)

(Copy of contract dated February 10, 1944, between Spencer Packing Company of Yakima and American Business Credit Corporation, thereupon received in evidence and marked Plaintiff's Exhibit No. 10.)

Mr. Jones: And we also offer Plaintiff's Pre-Trial Exhibit No. 11, contract between Spencer Packing Company of Yakima and the ABC.

The Court: Admitted.

(Copy of contract dated February 10, 1944, between Spencer Packing Company of Yakima

and American Business Credit Corporation, thereupon received in evidence and marked Plaintiff's Exhibit No. 11.) [83]

FREDERICK JOHNSON

was thereupon produced as a witness on behalf of the plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Jones:

Q. State your full name for the record.

A. Frederick Johnson.

Q. What is your business?

A. I am an accountant.

Q. CPA? A. Yes.

Q. Where did you go to school to study that?

A. I graduated from the University of Oregon.

Q. Are you a member of a state board or association of CPA's?

A. I am a member of the Oregon State Society of Certified Accountants and an associate member of the American Institute of Accountants.

Q. How long have you been engaged in the business—first, before that, what was the nature of your work or what is the nature of your work as a CPA?

A. I examine and analyze accounts, accounting records.

(Testimony of Frederick Johnson.)

Q. For whom are you employed at this time?

A. Mr. Robert T. Jacob.

Q. How long have you been employed by him?

A. Approximately two and a half years.

Q. For whom have you worked other than for
Mr. Jacob?

Mr. Garland: Objected to as incompetent.

A. I worked for the Federal Government prior
to that and with Price, Waterhouse & Company for
eleven years prior to that.

Q. (By Mr. Jones): Did you make an exami-
nation of the books, vouchers and records of the
Spencer Packing Company of Lebanon?

A. Yes.

Q. For the fiscal years ending February 28,
1943, February 28, 1944, and February 28, 1945?

A. Yes.

Q. And for the same period, did you examine
such records and books of the Spencer Packing
Company of Yakima? A. I did.

Q. And Spencer Dehydrators, Inc.?

A. Yes.

Q. And the personal accounts of Mr. C. B.
Spencer? A. Yes.

Q. Some of which are prior to this time under
the name of C. B. Spencer, doing business as the
Spencer Packing Company?

A. That is correct.

Mr. Winter: May I inquire the nature of Mr.
Johnson's testimony? Is it with respect to account-
ing issues?

(Testimony of Frederick Johnson.)

Mr. Jones: I am qualifying him to show that he inspected [85] the books and records and that they are summarized by the statement taken from the books.

Mr. Garland: Let us see your statement. Maybe we can agree on it.

Mr. Jones: I will give you a copy out of my file.

Mr. Garland: Have it identified. It will not take any longer than to have my man look it over.

Mr. Jones: I am going to hand this witness Pre-Trial Exhibits 35 and 36, 44, 48, 50, 53, 56 and 58.

Mr. Garland: We would like to say, your Honor, that these are statements prepared by this accountant. We want to expedite this file, but we cannot agree to these, particularly No. 58, summary of C. B. Spencer's bad debt account, Dehydrators, Inc., and Yakima Corporation. If that is typical of what they contend, we would like to scrutinize them carefully.

Mr. Jones: Wait until I finish with the witness, please. Mr. Bailiff, will you hand these exhibits that I have mentioned to the witness?

(Documents handed to the witness.)

Q. (By Mr. Jones): Did you prepare those?

A. Yes, sir.

Q. Will you state where you got the information for their preparation?

A. From the books and records, and supporting data of Spencer Dehydrators, Inc., the Spencer

(Testimony of Frederick Johnson.)

Packing Company of [86] Yakima, C. B. Spencer and, to a certain extent, from the records of the Spencer Packing Company of Lebanon.

Q. I would like you to look at this pile of books on the table here and see if these are the records to which you refer. You will have to look at the numbers on them. Maybe you had better step down to the table and look at them. The records you are looking at are Pre-Trial Exhibits 29, 30, 31, 32 and 33. You may resume the witness stand.

A. I used those books there, but it is possible some of these other records on the table were also used. I mean the other ledgers also.

Q. Would you make sure because, if they were used, we have got to offer them in evidence if these are admitted. Make sure before you go on. No. 34 was omitted. Is the other one you mentioned this?

A. Yes, sir.

Q. Will you answer the question, now?

Mr. Winter: These growers' contracts were for one year only. I want to be clear on that point.

A. Yes, these statements were prepared from Exhibits 29 to 33, I believe.

Q. (By Mr. Jones): 34?

A. And 34, yes.

Q. Now, I am also going to hand you the following pre-trial exhibits and ask you if, insofar as you were able to find [87] vouchers to support the book entries, if they are the vouchers summarized on those statements? I will read the numbers off

(Testimony of Frederick Johnson.)

to you here: 37; 39 and 40, 41, 43, 45, 46, 47, 49, 51, 52, 54, 55, 57. If I omitted 41 and 43, I mean to include them. Add No. 38 to that group. What is your answer to that question?

A. I believe that is correct.

Q. Is it correct or not? Look at them until you know.

A. I would have to check each one of these in detail to do that.

Q. Are you acquainted with the vouchers?

A. Yes, I am.

Q. Are they the vouchers that support the statements? A. I am sure they are.

Q. Just take a look at them for a minute.

The Court: Take him off the stand while he is looking at them and put on another witness.

Mr. Garland: I would like to ask the purpose of this.

The Court: Go and make a check of them and then you can have them admitted.

Mr. Jones: Call Mr. Powell.

(Witness temporarily excused.) [88]

BINGHAM POWELL

was thereupon produced as a witness on behalf of the plaintiff and, being first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Jones:

Q. Will you give your full name and address to the Clerk.

(Testimony of Bingham Powell.)

Q. Just speak a little louder, please. Where are you employed?

A. Spencer Packing Company.

Q. How long have you been employed there?—either by Mr. Spencer or as an individual or by some corporation or company that he has been interested in? A. Since August, 1942.

Q. Prior to being employed by him, for whom did you work?

A. Ladd & Bush Branch of the U. S. National Bank.

Q. Where? A. In Salem.

Q. What experience have you had as a book-keeper?

A. Approximately ten years with various banks.

Mr. Garland: We will agree to his qualifications.

Q. (By Mr. Jones): What relation are you to Mr. Spencer? A. His son-in-law.

Q. How long have you been married to his daughter? A. About seven years. [89]

Q. What was your office, if any, elective office, in the Spencer Packing Company of Lebanon?

A. Secretary-Treasurer.

Q. And in the Spencer Dehydrators, Incorporated? A. The same.

Q. And in the Spencer Packing Company of Yakima? A. Same.

Q. What did your duties consist of as secretary-treasurer of those three corporations?

A. Well, all duties which would normally fall to those classifications; secondarily responsible for all the records of the corporation.

(Testimony of Bingham Powell.)

Q. Who supervised the bookkeeping of the corporation? A. I.

Q. Did you do any of it personally?

A. I kept Mr. Spencer's personal books.

Q. And you supervised the books of the corporations? A. Yes.

Q. Would you step down and take a look at those books so you can identify them, Exhibits 29 to 34? Look at those so we will know what we are talking about.

Are you acquainted with the transactions recorded in those books during the years you were employed? A. Yes, sir.

Q. Have you gone back and examined into those years in [90] connection with your work?

A. In connection with my work it was necessary to go back to 1942.

Q. Do you know whether or not Mr. Spencer ever made any agreement with Spencer Dehydrators, Inc., concerning the accounts it owed to the Lebanon Corporation?

A. There was a definite agreement.

Mr. Winter: He asked you whether you knew or not. A. Yes.

Q. (By Mr. Jones): Will you give us the details of it?

Mr. Winter: We want to know the time and place and who was present.

The Court: He cannot do it all at once. Go ahead. Answer the question.

(Testimony of Bingham Powell.)

A. About the time that the corporations were formed, I definitely discussed the problem, and again from the standpoint of an officer of the corporations, as to how any moneys advanced by one corporation to the other should be treated, and it was definitely set forth that where, upon Mr. Spencer's instructions, moneys were advanced by one corporation to be used by another, that money should first be repaid by the corporation which received it but if, for any reason, it was unable to do so, Mr. Spencer would pay those funds back.

Q. (By Mr. Jones): When did this conversation take place between you and Mr. Spencer? [91]

A. The best I can say on that is it was approximately the time the corporations were formed.

Q. Where did it take place?

A. The initial discussion must have been in the office of Lebanon, where most of the things were done.

Q. How were the affairs of the corporations conducted with respect to that understanding?

A. They were conducted that way, definitely, as a program to be arrived at. That was a conclusion that we took up or acted towards.

Q. Both corporations understood it?

A. That is right.

Q. And was it followed consistently?

A. It was.

Q. There are some exhibits—I will have to hold up a moment. Counsel is looking at them, but I think we can go along with something else. Do you

(Testimony of Bingham Powell.)

know what activities Mr. Spencer, the plaintiff in this case, engaged in, if any, in addition to his duties as a corporate officer? A. Yes.

Q. Would you state them?

A. He engaged in all of the activities which were necessitated in enlarging and improving the various plants which he was leasing to those corporations. He, further, was responsible for arranging the finances of those corporations. [92]

Q. Can you give us any idea of the value of the additions, if any, he made to the plants during the years he was leasing them?

A. Well, of course, the actual figures are in the records, but I know it was better than a hundred thousand.

Q. Do you know of your own knowledge what understanding, if any, existed between the corporations and Mr. Spencer with respect to signing notes for the corporations? A. Yes, sir.

Q. Would you state it?

A. If for any reason, well, a corporation received money from a note, the corporation was to pay them back. If they could not pay them back, he would do so.

(Answer read.)

Q. How were the affairs of the corporations during this period of time conducted with relation to that?

A. They were conducted in that manner.

Q. Consistently? A. Yes.

(Testimony of Bingham Powell.)

Q. Do you know anything about the labels, or were you there at the end of the—no, you were not there at the end of the fiscal year ending February, 1943, were you?

A. Yes. You say the end of the year?

Q. Do you know anything about inventories of labels that were on hand at the end of that year?

A. Yes, sir.

Q. Will you explain what you know about those and how those were handled?

A. Well, I know that the labels were definitely charged off, written off as being valueless. Subsequently, some of those had been used. The reason for their use is the fact that there was a shortage of labels and labels were not available, and, so, there had been an imprinting done on those labels which could be modified to be used; there are others which are of the wrong size and which still cannot be used. There is also the fact that they are stored in the buildings which are not heated and there is some loss over a period of time from moisture and so forth.

Q. Can the labels that were included in that inventory be used without having new work done on them? A. No.

Q. When they were written off at the end of the year, February 28, 1943, were they regarded as having any value at all to the company?

A. They were regarded as worthless.

(Testimony of Bingham Powell.)

Q. Are you able to state into the record at this time Mr. Spencer's net worth from any records before us?

A. His net worth, at what time?

Q. During the spring of 1943?

A. From these records, yes. [94]

Q. Will you come down and take such records as you need from the books, and read it into the record?

The Court: Don't you have a financial statement around there some place, a copy of it?

Mr. Jones: No, because we only want to put in the income, expense and the nature of these bills.

The Court: You won't find it in his books?

A. Yes, he has an account of that.

The Court: You know how much it is. How much was he worth? A hundred thousand or two hundred thousand or what?

A. It was better than a hundred.

Mr. Jones: You read that from Pre-Trial Exhibit 33?

Mr. Garland: '43 or '33?

Mr. Jones: '43.

A. Testifying from Exhibit 33 and Exhibit 31.

Q. (By Mr. Jones): What do they show?

A. \$37,000 plus \$65,000.

Mr. Jones: We will offer those two exhibits in evidence.

Mr. Garland: Objected to.

Mr. Jones: We will offer in evidence at this time Pre-Trial Exhibits 29 to 34, inclusive.

The Court: Admitted.

(Books of account thereupon received in evidence and marked Plaintiff's Exhibits No. 29 to No. 34, inclusive.) [95]

Mr. Jones: I would like to have Mr. Johnson resume the stand.

FREDERICK JOHNSON

having been previously duly sworn, resumed the stand as a witness in behalf of the plaintiff, and further testified as follows:

Direct Examination

(Continued)

By Mr. Jones:

Q. Mr. Johnson, have you carefully checked the pre-trial exhibits, which are in the nature of vouchers, against the statements you have prepared?

A. Yes, sir.

Q. Are all of the vouchers, the exhibits in your hands there, that go to support the statements and book entries from which you got your figures?

A. All that could be located are here.

Q. Did you make any search to find any that could not be located? A. Yes, sir.

Q. About how much time did you spend on it?

A. I specifically spent half a day and then I was searching for these missing records at the time I was looking for others which were found.

(Testimony of Frederick Johnson.)

Q. Who helped you in your search?

A. Mr. Bingham Powell.

Q. All of the vouchers that could be found are there? [96] A. That is correct.

Q. Do the statements that you made directly reflect the figures that are on those books, Pre-Trial Exhibits 29 to 34, the statements you have in your hand? Do they correctly reflect the figures as you found them in the books? A. Yes.

Q. Pre-Trial Exhibit 35 is a balance sheet, purports to be a balance sheet, is that right?

A. That is right.

Q. A balance sheet of the Spencer Dehydrators just prior to when the corporation was liquidated, is that correct? A. That is correct.

Q. The figures are all correct and supported by the documents you have mentioned?

A. As far as the documents are available.

Q. Then, Exhibits 35, 42, 44 and 48 are summaries or detailed statements of the liability shown on the balance sheet, is that correct?

A. Yes, of Spencer Dehydrators, Incorporated.

Q. Pre-Trial Exhibits 53, 56 and 58 are detailed statements of certain of the liabilities appearing on those balance sheets, is that correct?

A. Does not include 58. It is correct, excluding 58.

Q. They stop with 56?

A. That is correct? [97]

(Testimony of Frederick Johnson.)

Q. On the first balance sheet mentioned, Pre-Trial Exhibit 35, the back overdraft is not shown, but do you have the bank's own statement to support that? A. That is correct.

Q. Is that also true with respect to taxes payable? Will you look at Pre-Trial Exhibit No.—there is a statement supporting taxes payable?

A. That is right.

Q. Can you explain the details of this sale of the Yakima property as shown on the books? Can you testify to that without looking at Exhibit 56?

A. No, I cannot testify.

Q. Refreshing your memory, will you explain the details of how the proceeds of the Yakima sale were handled?

Mr. Garland: There is no contest on that, no issue.

Mr. Jones: Very well. Then, I am going to offer all these statements at this time, except No. 58, which I will hold up for a special offer, and all of the voucher exhibits which I read into the record, all the vouchers supporting the statement I am offering in evidence.

Mr. Garland: We would like an opportunity to preserve an objection after looking at them. Most of these we have seen for the first time today.

Q. (By Mr. Jones): Pre-Trial Exhibit No. 58, can you explain what that is? [98]

A. That is a summary of Mr. Spencer's account with Spencer Dehydrators, Incorporated, shown on

(Testimony of Frederick Johnson.)

the books, written off as a bad debt, and Spencer Packing Company of Yakima, that was brought about in the same way.

Q. Does that give the details of the two bad debts that plaintiff is claiming in this case?

A. Yes, sir, as shown by the books.

Q. Are the statements that you prepared, Exhibits 35, 36, 42, 44, 48, 50, 53 and 56, those that lead up to and explain Exhibit 58, and show the final analysis of a bad debt? A. Yes.

Q. Is Exhibit 58 the only one that you need to look to to get the final picture of what the bad debt is?

Mr. Garland: We want to object to the characterization. Let the record show that any place that appears, either in question or answer or in these summaries, that it is not to be given significance.

Mr. Jones: I think that is perfectly fair. I am trying to avoid any characterization.

Q. The amounts that Mr. Spencer claims against Dehydrators, Inc., and the Yakima Corporation that we are litigating in this case, whether or not they are bad debts, are those appearing in the summary, Exhibit 58? A. Yes.

Mr. Garland: Where you use the words "bad debt," it should [99] be given no significance.

Mr. Jones: I will come to that.

Mr. Garland: I say, is that correct?

Mr. Jones: Just a second, now. I do not think it appears on this particular one.

Mr. Garland: It appears on 58.

(Testimony of Frederick Johnson.)

Mr. Jones: I am looking at that now.

Mr. Garland: That is the way it is set up at the pre-trial hearing.

Mr. Jones: It is agreed on No. 58 that nothing is claimed in the way of any evidentiary value by the use of the term "bad debt."

Mr. Garland: Let me ask you: Does that same apply to any exhibit you have there?

Mr. Jones: Yes.

Mr. Garland: That is all I wanted to know.

Q. (By Mr. Jones): I do want to ask one question in connection with that, however. Is there any kind of bad debt account in Mr. Spencer's books?

A. Yes, sir.

Q. And these amounts shown on Exhibit 58 of \$73,601.46 and \$33,966.02, have they been charged off as bad debts on that account?

A. The total of \$107,567.51 has. I believe there are three amounts in there. One of them is, I think, \$601.49, [100] the other, \$30.22, and \$33,930 and something.

Q. My question was, specifically: Are the two amounts I named charged off in that account as bad debts? A. Yes.

Q. Do the books show when this liquidation was completed? A. Yes, sir.

Q. What date? A. February 15, 1945.

Q. Do the books show what was paid in as capital? A. Yes.

Q. What? A. The growers' contracts.

(Testimony of Frederick Johnson.)

Q. Do they set a value on those growers' contracts? A. The books do.

Q. What?

A. An amount equal to the capital stock which, in the case of Spencer Dehydrators, Inc., was \$5,000 and in the case of Spencer—

Mr. Winter: I believe that is already in the record.

Q. (By Mr. Jones): Do the books show whether those amounts were written off?

A. Yes.

Q. Completely? A. Yes.

Q. All the growers' contracts were written off?

A. That is correct.

Q. Is there any account in the books anywhere, either of the corporations or of Mr. Spencer's, showing any contribution to capital other than those growers' contracts?

Mr. Garland: That is immaterial.

The Court: He may answer.

A. No.

Q. (By Mr. Jones): Do the books or the records show that the liabilities of the Dehydrators, Incorporated, were taken over or taken up on Mr. Spencer's own books as obligations to be paid by him?

A. Mr. Spencer's books show that those items were regarded as liabilities.

(Testimony of Frederick Johnson.)

Q. Do the records show whether or not all of the amounts which we claim are obligations due him from the Yakima and Dehydrators, Inc., whether they are paid by him?

A. These records show they were all paid with the exception of one item of \$3.68.

Q. Does the record show what he did as to that?

A. That was taken up in his profit and loss account under date of February 28, 1946.

Q. As income to him? A. That is correct.

Q. Do the books indicate whether or not there are any outstanding assets, or any claims for money or anything else [102] belonging to either of the corporations last mentioned which have not been brought into the assets shown on your statement?

A. There was one item recorded subsequently to February 28, 1945, I believe.

Q. What is that?

A. That was the realization of a claim against—

Q. That is the \$12,000 that has been admitted?

A. That is correct.

Q. Was there any other? A. None.

(A short recess was then taken.)

Q. (By Mr. Jones): I will ask you if the records show the date that Mr. Spencer picked up or accrued these liabilities? I asked you if he accrued these liabilities on his books but I did not ask you the date. A. February 15, 1945.

Q. Was that also the date on which the growers' contracts were written off? A. Yes.

(Testimony of Frederick Johnson.)

Q. Was it on that date that liquidation took place?

A. Closed entries on the books of the Yakima and Dehydrator corporations as of the same date, which was February 15, 1945.

Q. And that was the date—

A. —the liabilities were recorded on Mr. Spencer's books at the same time. [103]

Q. The question specifically is: Is that the date the growers' contracts were written out of the capital account? A. That is correct.

Mr. Winter: The growers' contracts were only written for one year. Just so I understand it and so the Court understands it—

The Court: I understand it. Don't worry about me.

Mr. Winter: I wanted to be sure.

The Court: Be sure for yourself.

Mr. Winter: That is why I wanted to ask that.

Q. (By Mr. Jones): Referring again to this Exhibit 56, which shows the disposition of the proceeds of the sale of the Yakima plant, I want you to state whether or not that exhibit accurately shows just where all of the proceeds went, if it details where all the proceeds went?

A. It does.

Q. Some of those proceeds went to pay Dehydrators and one previously went to pay a bill of C. B. Spencer's personally. Do the books show whether or not the Yakima Corporation received

(Testimony of Frederick Johnson.)

credit for all sums, for all amounts that were paid out of those proceeds that did not go to pay its own obligations?

A. The books do show that Yakima received credit for such items.

Q. In other words, if it paid out for the benefit of [104] Dehydrators, those companies gave credit?

A. That is correct.

Q. Or else it charged those companies for it?

A. That is right.

Q. I asked you if there was any kind of a book that showed any contribution other than growers' contracts to capital, but I did not include the word "payment."

Was there any payment of any money or anything else? I do not want to just limit it to the word "contribution." I want to know if there was any money or anything else that went into any capital account, or any account like a capital account, other than the growers' contracts?

A. There was none.

Q. Do the books show on what basis Mr. Spencer keeps his account?

A. His account—his books are kept on an accrual basis.

Q. That shows in the books themselves?

A. It is obvious, I would say.

Q. A time or two I probably used the words, in examining you, "picking up a liability." What do you understand I meant by that?

(Testimony of Frederick Johnson.)

A. By "picking up a liability" I would say it means accruing a liability.

Q. And that is how you used the term?

A. Yes. [105]

Mr. Jones: I have made an offer of these statements that we had prepared, together with the vouchers that support them, and I suppose I can renew that offer after we have checked these exhibits over. Will you check them so I can make my offer?

The Court: Proceed with the cross-examination.

Cross-Examination

By Mr. Garland:

Q. The books in evidence, the books of Mr. Spencer, do they show any cost basis of the growers' contracts to the Dehydrators, Inc., or Yakima Corporation?

A. I do not recall checking for that specifically. I would presume they do. I would answer that by looking at the books.

Q. How long would it take?

A. Well, I don't know. I would be glad to take a look and see what I can find.

Mr. Garland: The books are in evidence. We will withdraw the question. That is all.

(Witness excused.) [106]

BINGHAM POWELL

having previously been duly sworn, was recalled as a witness on behalf of the plaintiff and was examined and testified as follows:

Direct Examination

By Mr. Jones:

Q. When Mr. Spencer would tell you about a transaction that originated with him, what would you do about it?

A. I would enter it in the books.

Q. You entered all transactions which he called to your attention? A. Yes.

Q. And all transactions which you knew about?

A. Yes.

Mr. Jones: As far as I know, the income is not challenged. I won't go into that.

Mr. Winter: It is challenged insofar as additional assessments are concerned.

Mr. Jones: Oh, yes.

Mr. Winter: We have introduced certified copies of the assessments.

Mr. Jones: Yes, that is right.

Q. Are you acquainted with the details of the various transactions recorded in these books and received in evidence, the exhibits that Mr. Johnson prepared and testified about? A. Yes. [107]

Q. You have looked these exhibits over?

A. Yes.

Q. Did you help search for the few missing papers, vouchers? A. I did.

(Testimony of Bingham Powell.)

Q. Approximately how much time did you put in?

A. Well, I put in quite a lot of time, because I searched off and on over several weeks at different times and, even while I was looking for one thing, I would keep other things in mind for which we were searching.

Mr. Winter: We have agreed on the amount.

Mr. Jones: That is right. Nothing further on that.

Q. As you left the stand, you testified about Mr. Spencer's activities other than as officer or director of the corporations. Approximately how much time would he expend in such activities?

A. He spent a great deal, anywhere from thirty to forty per cent.

Q. Did he receive any salary as an officer of any of the companies? A. No.

Q. Or as a director? A. No, sir.

Q. I think you had just started to detail what he did. I wish you would elaborate upon that a little bit. That is something that might be of importance in this case. [108]

A. Well, one of the things was expanding the plant, which meant construction of buildings and purchasing of materials, also the purchase of machinery that went into those buildings, the arrangement and redesigning of existing plant to conform with those additions. At that time, equipment and machinery was quite difficult to get. We had the problem of priorities entering into it and he spent

(Testimony of Bingham Powell.)

some time in searching for items which he wanted to use. Beyond that, at times it was necessary to travel, perhaps to Washington, relative to priorities, or to California relative to contracts with machinery companies in the purchasing of these machines, numerous things along that line.

Q. All those machines and plants, were they owned by him as an individual?

A. They were.

Q. They were on the leases with the canneries?

A. Yes.

Q. Do you know approximately what the dollar volume of the promissory notes he signed would amount to?

Mr. Garland: Objected to. The notes are in evidence, your Honor.

Q. (By Mr. Jones): Do you know approximately how many of those notes he signed? They are not all in evidence.

A. Well, they would be hundreds.

Q. This question has been asked twice, but you know best of [109] all. Mr. Spencer's books were on an accrual basis? A. Yes.

Q. What was the intention of the directors when the growers' contracts were transferred in payment of the capital stock, as to whether or not it was full payment, do you know?

A. It was definitely accepted as full payment.

Q. Full payment of the capital stock?

A. Yes.

(Testimony of Bingham Powell.)

Q. Did either Yakima or Dehydrators make any money? A. No, sir.

Q. Both operated at a loss?

A. Both operated at a loss, yes.

Q. Will you state the plan of liquidating the two corporations?

A. In the case of Dehydrators, the reason for liquidation was definitely no further necessity for the product that it was producing—had been producing at a loss—and, in checking with Government agencies that had been taking this product, Spencer was definitely advised that there was no use attempting to operate further; it was definitely indicated that there wasn't to be a commercial market for that product and, therefore, no reason at all to operate.

The Court: What was your dollar volume in those two plants?

A. I would have to look at the books on that.

The Court: Well, how much, about? How many employees did you have?

Mr. Jones: What year?

The Court: I don't care, any year. Twenty-five, fifty or a hundred?

A. Well, Dehydrators must have had in the neighborhood of a hundred and Yakima probably had several hundred, three or four hundred.

The Court: Give the dollar volume for any year. Did you have contracts that were to be paid in terms of dollars? Dollar value?

A. The easiest way to show that would be to check the dollar sales.

(Testimony of Bingham Powell.)

The Court: I do not want to check anything. I want you to tell me. Did you sell a million dollars in any year or two million dollars worth?

Mr. Jones: You know what the sales were at Yakima.

The Court: You had a hundred employees at one plant and three or four hundred at another. You must have sold a lot of stuff.

Q. (By Mr. Jones): At Yakima, what was the reason they closed up?

A. There had been an unprofitable season and it was brought about, to a great extent, by shortage of labor and a combination of high prices for fruit, cans, and controlled prices [111] for the finished product, and the plant had to operate at full capacity in order to be economically feasible, and there was definitely every reason to think that labor was going to be more difficult to secure later, rather than easier.

Q. What was the plan of liquidating?

A. In Yakima, the plant was sold by Mr. Spencer in the summer. The funds were—

Q. The summer of what year?

A. 1944, and the funds from that sale were applied by the corporation, first, to all general creditors and then, secondly—some were held by ABC for Spencer Dehydrators and Spencer of Lebanon's note, and then there were a very few assets which were liquidated during that summer. In February, any assets and liabilities which remained or, rather,

(Testimony of Bingham Powell.)

any assets which remained were taken by Mr. Spencer and, with one exception all the remaining liabilities were against him.

Q. What is that?

A. With one exception, the remaining liabilities were against him, and he charged that liability off.

Q. The assets taken over, how were they applied in Yakima? What did he do with the assets?

A. Any assets taken over were applied against the indebtedness which they owed to him. [112]

Q. In the full amount?

A. To any amount that was ever realized. Yes.

Q. With respect to Dehydrators—

A. In the case of Dehydrators, he took over the assets, applied them specifically against Dehydrators' liabilities and then he paid the balance of the liabilities himself, charging the difference to bad debts. The only other thing, several months later, in an audit by War Foods it disclosed—

Q. That has all been admitted in evidence. I started to ask you—I did not quite finish. These transactions that you could not find the missing vouchers for, how long would it take you to get the information out of the books?

The Court: No. You ask Mr. Spencer over here. Ask Mr. Spencer. He knows what the business was.

Mr. Jones: Mr. Spenceer, do you know what the sales for Yakima were in 1943?

Mr. Spencer: I think between seven hundred thousand and a million dollars. As far as employees were concerned, we had some six hundred employees

(Testimony of Bingham Powell.)

at the Yakima operation and over a hundred at the Dehydrators' operation and practically six hundred at the Lebanon operation.

The Court: Were you the biggest employer in Lebanon?

Mr. Spencer: No, sir. Yes, we were the largest employer in Lebanon. We were exceeded in Yakima by both [113] Libby—

Q. (By Mr. Jones): All the amounts that go to make up the claims that Mr. Spencer is making against the Yakima and Dehydrators, do those amounts represent the expenditures made by those two corporations? Do those amounts represent obligations incurred by those two corporations?

A. Yes.

Q. For what purpose?

A. Normal course of business.

Q. Operating expenses? A. Yes.

Q. Were any of them for capital assets?

A. None represent capital assets.

Q. These books here, Exhibits 29 to 34, they are all books belonging either to Mr. Spencer or the corporations as indicated on the outside of them?

A. Yes.

(Balance Sheet, Spencer Dehydrators, Inc., February 15, 1945, thereupon received in evidence and marked Plaintiff's Exhibit No. 35.)

(Statement of Notes Payable, ABC, Spencer Dehydrators, Inc., thereupon received in evidence and marked Plaintiff's Exhibit No. 36.)

(Testimony of Bingham Powell.)

(Statement of Accounts Payable, Miscellaneous, Spencer Dehydrators, Inc., thereupon received in evidence and marked Plaintiff's Exhibit No. 42.)

(Statement of Accounts Payable, Spencer Dehydrators, Inc., Paid by C. B. Spencer, thereupon received in evidence and marked Plaintiff's Exhibit No. 44.)

(Statement of Taxes Payable, Spencer Dehydrators, Inc., thereupon received in evidence and marked Plaintiff's Exhibit No. 48.)

(Balance Sheet, Prior to Recording Closing Entries, Spencer Packing Company of Yakima, thereupon received in evidence and marked Plaintiff's Exhibit No. 50.)

(Statement of Accounts Receivable from Spencer Packing Company of Yakima thereupon received in evidence and marked Plaintiff's Exhibit No. 53.)

(Statement of Disposition of Proceeds from Sale of Yakima properties thereupon received in evidence and marked Plaintiff's Exhibit No. 56.)

(Summary of Bad Debts Claimed against Spencer Dehydrators, Inc., and Spencer Packing [115] Company of Yakima thereupon received in evidence and marked Plaintiff's Exhibit No. 58.)

Mr. Jones: You may cross-examine.

(Testimony of Bingham Powell.)

Cross-Examination

By Mr. Garland:

Q. You have spoken of the activities of Mr. Spencer. A. Yes.

Q. After the corporations were formed?

A. Yes.

Q. These activities that you speak of, were those of a president and manager of a corporation, were they not?

A. I did not have that impression, sir.

Q. What were they?

A. Like I reiterated—

Q. I don't care for you to restate what they were, but were they not the ordinary activities of a president and manager of a cannery plant?

A. The particular companies did not own any capital assets and, therefore, there would be no way that their president would be involved in the purchasing or building and such things as that.

Q. Every president is involved in managing and operating a cannery. Were his activities those you would expect in a person in that position? [116]

A. I was talking primarily about his activities relative to expansion of the plant.

Were the growers' contracts carried on the personal books of Mr. Spencer at any value?

A. No, sir.

Q. Was the stock of Dehydrators carried on his books at any value? A. Yes.

Q. What value? A. Par value.

(Testimony of Bingham Powell.)

Q. What was that? A. Dehydrators?

Q. Yes. A. Dehydrators was \$5,000.

Q. Was the stock of the Yakima plant carried at any value? A. At par value.

Q. And that was the same? A. \$10,000.

Q. Are you familiar with the Federal income tax returns for the fiscal year ending February 28, 1945, of Mr. Spencer?

A. I did not prepare his tax statement.

Q. Are you familiar with whether or not there was any deduction shown for capital loss on account of the stock of the Dehydrators, Inc., and the Yakima Corporation?

A. I hardly think I would be qualified to answer that [117] question.

Mr. Garland: May the record show that there was none claimed on the income tax return for the fiscal year ending February 28, 1945? That is all.

(Witness excused.)

Mr. Jones: There is one exhibit here, No. 73, which was prepared by Mr. Johnson from the books. It is a depreciation schedule. You have admitted all the figures. The only reason I want this in is that it shows the dates and the amounts of the acquisitions. I would like it in evidence. I believe I will offer it. I will call Mr. Johnson and have him testify to it.

Mr. Winter: His returns which are in evidence will show the depreciation which you claim. There is no issue about depreciation.

Mr. Jones: Have you checked against the returns? Are all the items on the returns?

Mr. Garland: I do not think it is material. There is no depreciation question involved.

Mr. Jones: We are only offering it to show acquirements, the acquirements shown by this column of additions. I am offering it for the purpose of showing exactly what we acquired.

Mr. Winter: You mean assets acquired and used by these [118] corporations?

Mr. Jones: Assets which Mr. Spencer personally bought and were owned by him and rented to the corporations.

Mr. Winter: May I see the Revenue Agent's report?

Mr. Jones: I am offering it for the limited purpose of showing the amount of the machinery and plant facilities acquired during the years we claim he was engaged in the business of leasing the plants.

The Court: Admitted.

(Tabulation in longhand entitled "Depreciable Assets and Related Depreciation, Year Ending February 28, 1943," thereupon received in evidence and marked Plaintiff's Exhibit No. 73.)

Mr. Jones: With the exception of renewing our offer of the exhibits identified at the pre-trial and which have not so far been received, we are ready to close our case. I would like an opportunity of checking those to make sure.

Mr. Garland: Going to introduce the Revenue Agent's report?

Mr. Jones: I introduced the Revenue Agent's report, but these things that you have produced have not yet been marked. I can look these over and introduce them later.

The Court: No.

Mr. Jones: Introduce them in the morning.

The Court: No, we are going to finish tonight.

Mr. Winter: It may be understood that the Revenue Agent's report may be admitted, if it has not already been?

The Court: Yes.

Mr. Jones: In order to speed it up, your Honor, and make sure that I have got all my exhibits in, I am going to offer——

The Court: All right. I will tell you how to speed it up. Plaintiff is resting, subject to reopening if you find you have omitted something. Put on your case for the Government.

Mr. Garland: I would like to introduce, if the Court please, the assessment lists heretofore offered for identification as Pre-Trial Exhibits 74 and 75.

The Court: Admitted.

(Certified copy of assessment list, December, 1946, against C. B. Spencer, thereupon received in evidence and marked Defendant's Exhibit No. 74.)

(Certified copy of telegraphic assessment, C. B. Spencer, thereupon received in evidence and marked Defendant's Exhibit No. 75.)

Mr. Garland: We would like to renew our request that the case remain open until we can take our depositions. [120]

Mr. Jacobs: On that point, if I may be heard, whose depositions are to be taken?

Mr. Winter: We want to take the deposition of H. G. Bauer, Alice Berry and two bankers. I will give you their names. A. R. Munger and C. R. Watkins. They all live in Seattle. However, the Alice Berry deposition will have to be taken at Yakima. The others may be taken at Seattle. We would like to take the depositions on oral interrogatories.

Mr. Jacob: Depositions have already been taken of all of these parties. The special agent is here who took those depositions and photostatic copies were made of all records of H. G. Bauer that are pertinent and at the time the depositions were taken Mr. Winter was notified that they were to be taken.

The Court: How soon can you take these depositions?

Mr. Winter: Next week, your Honor.

The Court: Can you take them next week?

Mr. Jacobs: I believe we can.

Mr. Winter: I don't know the name of a Reporter that I can get in Seattle, or a Notary Public, but I will ascertain and I will possibly want to take the same Notary over to Yakima to take the deposition over there.

Mr. Jones: Some of these exhibits that you have I wish to offer in evidence, and I would like to know that all pre-trial exhibits that have not been formally offered are [121] in. Those starting at No. 65 and on I believe have already been admitted, but below No. 65, I am offering them all in evidence.

The Court: All admitted.

Mr. Jones: All admitted? Thank you.

(The following plaintiff's pre-trial exhibits were thereupon received in evidence and marked as follows:)

| Plaintiff's Exhibits: | Description |
|--------------------------|---|
| 3 | Certificate of Necessity. |
| 18 | Letter August 18, 1943, Food Distribution Administration to Spencer Packing Company of Lebanon. |
| 19 | Letter of February 3, 1944, Food Distribution Administration to Speneer Packing Company of Lebanon. |
| 20 | Copy of Negotiated Contract, August 22, 1944, War Food Administration and Spencer Packing Company of Lebanon. |
| 22 | Copy of letter May 10, 1945, C. B. Spencer to Commissioner of Internal Revenue—Election to Terminate Amortization Period. |
| 23 | Letter May 28, 1945, Treasury Department to C. B. Spencer, re: Non-Necessity Certificate File. |
| 24 | Certified copy Individual Income Tax Return, February 28, 1942, C. B. Spenceer. |
| 37 | Vouchers supporting statement of notes payable, \$11,261.19—Spencer Dehydrators. |
| 41 | Check March 6, 1945, \$9,934.02, C. B. Spencer, payable to First National Bank of Lebanon. |
| 43 | Voucher supporting Exhibit No. 42. |
| 45 | Vouchers supporting Exhibit No. 44. |
| 46 | Vouchers supporting Exhibit No. 44. |
| 47 | Vouchers supporting Exhibit No. 44. |
| 49 | Vouchers supporting Exhibit No. 48. |

Plaintiff's

Exhibits:

Description

51 Accounts Payable, Yakima Corporation — Sunnyside Packing Company.
52 Statement and letter regarding Yakima account, Personal Property Taxes Levied on Exhibit 50.
54 Vouchers—Rent Charged on Exhibit 53.
55 Vouchers supporting other items on Exhibit 53.
57 Vouchers supporting Exhibit No. 56.
59 Articles of Incorporation, Spencer Packing Company of Lebanon.
60 Articles of Incorporation, Spencer Dehydrators, Inc.
61 Articles of Incorporation and Minutes of First Meeting of Board of Directors of Yakima Corporation.
62 Form of Growers' Contract.
63 Revenue Agent's Report.
64 Transcript of Proceedings before Judge Fee July 8, 1945.

(Adjournment.)

[Title of District Court and Cause.]

Reporter's Certificate

I, Ira G. Holcomb, Reporter pro tem of the above-entitled Court, do hereby certify that on Tuesday, the 17th day of December, A.D. 1946, I reported in shorthand certain proceedings occurring in the trial of the above-entitled case; that I thereafter caused my shorthand notes to be reduced to typewriting, and that the foregoing transcript, consisting of 124 pages, numbered 1 to 124, both inclusive, constitutes a full, true and accurate transcript of said proceedings so taken by me in shorthand on said date, as aforesaid, and of the whole thereof.

Dated this 7th day of January, A.D. 1947.

/s/ IRA G. HOLCOMB,

Reporter pro tem.

[Endorsed]: No. 11834. United States Circuit Court of Appeals for the Ninth Circuit. J. W. Maloney, United States Collector of Internal Revenue for the District of Oregon, Appellant, vs. C. B. Spencer, Appellee. Transcript of Record. Upon Appeal from the District Court of the United States for the District of Oregon.

Filed January 19, 1948.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

United States Circuit Court of Appeals
for the Ninth Circuit

No. 11834

J. W. MALONEY,

Appellant,

vs.

C. B. SPENCER,

Appellee.

ORDER

This matter coming on to be heard this date upon motion of Henry L. Hess, United States Attorney for the District of Oregon, and Floyd D. Hamilton, Assistant United States Attorney, for an Order extending time for filing of the record and docketing the appeal in the within action for the reason that appellant has filed in the District Court a Designation of Contents of Record on Appeal and a Statement of Points upon which Defendant Intends to Rely on Appeal but the District Court will not be able to prepare and docket the record on appeal in the Circuit Court of Appeals within the time set therefor, and the Court having considered said motion and supporting affidavit and being advised in the premises,

It Is Ordered that the time for filing the record on appeal in the within action be, and it is hereby, extended thirty (30) days from and after December 18, 1947.

Made and entered at San Francisco, California,
this 18th day of December, 1947.

/s/ FRANCIS A. GARRECHT,
Judge.

[Endorsed]: Filed December 18, 1947.

[Title of Circuit Court of Appeals and Cause.]

APPELLANT'S STATEMENT OF POINTS ON
WHICH HE INTENDS TO RELY ON AP-
PEAL AND DESIGNATION OF RECORD
FOR PRINTING.

Comes now J. W. Maloney, Collector of Internal Revenue for the District of Oregon, appellant above named, and for a statement of points upon which he intends to rely on this appeal says:

The statement of points to be urged by appellant in this Court are the same as those set forth in the statement of points filed with the District Court pursuant to Rule 75 (d) of the Federal Rules of Civil Procedure.

Appellant designates for printing the entire record filed with this Court except the transcript of proceedings of February 25, 1947, which relates solely to issues from which no appeal is being taken.

Dated this 15th day of January, 1948, at Portland, Oregon.

HENRY L. HESS,
United States Attorney for
the District of Oregon.

/s/ FLOYD D. HAMILTON,
Assistant United States
Attorney.

State of Oregon,
County of Multnomah—ss.

Due service of the foregoing Appellant's Statement of Points on which he Intends to Rely on Appeal and Designation of Record for Printing to the United States Circuit Court of Appeals for the Ninth Circuit is hereby accepted at Portland, Oregon, this 15th day of January, 1948, by receiving copy thereof, duly certified as such by Floyd D. Hamilton, Assistant United States Attorney, of Attorneys for Appellant.

/s/ RANDALL S. JONES,
Of Attorneys for Appellee.

[Endorsed]: Filed January 19, 1948.

No. 11834

In the United States
Circuit Court of Appeals
for the Ninth Circuit

J. W. MALONEY, United States Collector of Internal
Revenue for the District of Oregon, Appellant,

v.

C. B. SPENCER, Appellee

UNITED STATES OF AMERICA, Interpleader-Appellant

On Appeal from the District Court of the United States
for the District of Oregon

BRIEF FOR THE COLLECTOR AND THE
UNITED STATES

THERON LAMAR CAUDLE,
Assistant Attorney General.

SEWALL KEY,
GEORGE A. STINSON,
S. DEE HANSON,

*Special Assistants to the
Attorney General.*

HENRY L. HESS,
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VICTOR E. HARR,
Assistant United States Attorney.

THOMAS R. WINTER,
*Special Assistant to the
United States Attorney.*

FILED

MAY 19 1948

PAUL P. O'BRIEN,
O'Brien

INDEX

| | Page |
|---|------|
| Opinion below | 1 |
| Jurisdiction | 1 |
| Question presented | 3 |
| Statute involved | 4 |
| Statement | 4 |
| Statement of points to be urged..... | 12 |
| Summary of argument | 13 |
| Argument: | |
| The taxpayer is not entitled to carry back and deduct for the taxable year 1944 the net operating loss alleged to have been suffered in 1945..... | 15 |
| A. The taxpayer's financing only his own corporations instead of cannery or other corporations generally, did not constitute the operation of a trade or business regularly carried on by him.. | 17 |
| B. The taxpayer's advancements and exten- sion of his credit to his three wholly- owned corporations represented cap- ital investments | 31 |
| Conclusion | 40 |
| Appendix | 41 |

CITATIONS

| | Page |
|---|--------------------|
| <i>Cases:</i> | |
| <i>American Cigar Co. v. Commissioner</i> , 66 F. 2d 425, certiorari denied, 290 U. S. 699 | 35 |
| <i>Averill v. Commissioner</i> , 20 B.T.A. 1196..... | 30 |
| <i>Bingham, Trust of v. Commissioner</i> , 235 U. S. 365.... | 23 |
| <i>Burnet v. Clark</i> , 287 U. S. 410..... | |
| 23, 28, 29, 31, 34, 35, 37 | |
| <i>Cohen v. Commissioner</i> , 148 F. 2d 336..... | 21, 35, 37 |
| <i>Conrades v. Commissioner</i> , 21 B.T.A. 213..... | 30, 31 |
| <i>Corn Exchange National Bank & Trust Co. v. Commissioner</i> , 46 B.T.A. 1107..... | 35 |
| <i>Dalton v. Bowers</i> , 287 U. S. 404..... | 26, 29, 31, 34, 35 |
| <i>Deputy v. duPont</i> , 308 U. S. 488..... | 28, 36 |
| <i>Doyle v. Mitchell Brothers Co.</i> , 247 U. S. 179..... | 34 |
| <i>Gulf Oil Corp. v. Lewellyn</i> , 248 U. S. 71..... | 34 |
| <i>Gregory v. Helvering</i> , 293 U. S. 465..... | 34 |
| <i>Griffiths v. Commissioner</i> , 308 U. S. 355..... | 34 |
| <i>Gruver v. Helvering</i> , 70 F. 2d 292..... | 29 |
| <i>Helvering v. Northwest Steel Mills</i> , 311 U. S. 46..... | 17 |
| <i>Hickey v. Chahoon</i> , 153 F. 2d 107, certiorari denied, 328 U. S. 843 | 37 |
| <i>Higgins v. Smith</i> , 308 U. S. 473..... | 34 |
| <i>Howell v. Commissioner</i> , 69 F. 2d 447, certiorari denied, 297 U. S. 654 | 37 |
| <i>Jackson v. United States</i> , 230 U. S. 1..... | 23 |
| <i>Janeway v. Commissioner</i> , 2 T. C. 197, affirmed, 147 F. 2d 602 | 35, 36 |

Page

Cases (Continued):

| | |
|--|----|
| <i>Katzinger, Edward, Co. v. Commissioner</i> , 44 B.T.A. | |
| 533, affirmed, 129 F. 2d 74..... | 39 |
| <i>Kittredge v. Commissioner</i> , 88 F. 2d 632..... | 30 |
| <i>McCaughn v. Real Estate Co.</i> , 297 U. S. 606..... | 22 |
| <i>New Colonial Co. v. Helvering</i> , 292 U. S. 435..... | 17 |
| <i>Park's Estate, In re.</i> , 58 F. 2d 965, certiorari denied, 287 U. S. 645 | 37 |
| <i>Rassenfoss v. Commissioner</i> , 158 F. 2d 764..... | 23 |
| <i>Stephenson v. Commissioner</i> , 101 F. 2d 33, certiorari denied, 307 U. S. 647..... | 29 |
| <i>Tyler v. United States</i> , 281 U. S. 497..... | 34 |
| <i>United States v. Stewart</i> , 311 U. S. 60..... | 17 |
| <i>U. S. Trust Co. v. Helvering</i> , 307 U. S. 57..... | 17 |
| <i>Van Dyke v. Commissioner</i> , 23 B.T.A. 946, affirmed, 63 F. 2d 1020, affirmed, 291 U. S. 642, rehear- ing denied, 291 U. S. 650 | 29 |
| <i>Watson v. Commissioner</i> , 124 F. 2d 437..... | 29 |
| <i>Welch v. Helvering</i> , 290 U. S. 111..... | 37 |
| <i>White v. United States</i> , 305 U. S. 281..... | 17 |

Statute:

Internal Revenue Code:

| | |
|--|--------------------------------|
| Sec. 23 (26 U.S.C. 1940 ed., Sec. 23)..... | 12, 13, 32, 33 |
| Sec. 122 (26 U.S.C. 1940 ed., Sec. 122)..... | 10, 12, 13, 15, 16, 17, 18, 23 |
| Sec. 122 | 32, 33, 39 |

In the United States
Circuit Court of Appeals
for the Ninth Circuit

No. 11834

J. W. MALONEY, United States Collector of Internal Revenue for the District of Oregon, Appellant,

v.

C. B. SPENCER, Appellee
UNITED STATES OF AMERICA, Interpleader-Appellant

On Appeal from the District Court of the United States
for the District of Oregon

BRIEF FOR THE COLLECTOR AND THE
UNITED STATES

OPINION BELOW

The District Court wrote no opinion.

JURISDICTION

This appeal involves individual income taxes of the appellee (hereinafter called the taxpayer) for the fiscal

year ended February 29, 1944. (R. 3, 6-42, 69, 78.) The aggregate amount of taxes¹ in dispute was assessed (together with victory taxes) pursuant to the taxpayer's amended income and victory tax return filed for such taxable year on or about June 15, 1944, and was paid to and collected by the Collector on or about October 8, 1943, February 19, 1944, and March 22, 1945. (R. 3, 69.) A claim for the refund thereof was timely filed by the taxpayer on or about April 21, 1945, and more than six months had elapsed between the dates of filing the claim and the filing of this action without any notice of allowance or rejection of the claim having been sent to the taxpayer in the meantime by the Commissioner of Internal Revenue. (R. 4, 78.) On

(1) The exact amount of the tax in dispute is not ascertainable from the record. The suit was brought for the recovery of income taxes paid for the fiscal year ended February 29, 1944, in the sum of \$93,565.04. (R. 2-5.) The District Court indicated in its findings of fact that the taxpayer had "overpaid" his income taxes in the amount of \$78,659.03 (R. 78), which it held the taxpayer is entitled to recover, with interest according to law and costs (R. 81), and thereupon entered judgment in favor of the taxpayer for such amount accordingly (R. 83-84). Inasmuch as the court below decided all three issues involved in the case in favor of the taxpayer (R. 79-82), and the Government's appeal involves only the first issue (R. 87-89), the precise amount of income tax relating to and dependent upon the decision of that issue is not determinable from the record. The correct amount, however, will eventually be determined by the Collector according to the final outcome of the case.

October 27, 1945, within the time provided by Section 3772 of the Internal Revenue Code, the taxpayer brought this suit for the recovery of the taxes in dispute and interest according to law. (R. 2-42.) Jurisdiction was conferred upon the District Court by Section 24, Fifth, of the Judicial Code, as amended. The judgment was entered on June 24, 1947, in favor of the taxpayer, with costs (R. 83-84.) Thereafter, within three months, notice of appeal was filed by the Collector and the United States, as interpleader, on September 19, 1947. (R. 85.) The jurisdiction of this Court is invoked by the provisions of Section 128 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

Whether the taxpayer was entitled to carry back to the taxable year ended February 29, 1944, the net operating losses alleged to have been sustained during the fiscal year ended February 28, 1945, within the meaning of Section 122 of the Internal Revenue Code.

Determinative of this issue are the questions (1) whether the taxpayer was engaged in a statutory trade or business regularly carried on by him by financing only his three wholly-owned and controlled cannery corporations during the taxable year, and (2) whether the taxpayer's extension of his credit, by endorsing their notes, to finance his three wholly-owned and managed canneries represented ordinary debts or capital investments.

STATUTE INVOLVED

This is set forth in the Appendix, *infra*.

STATEMENT

The pertinent facts in respect of the issue appealed herein, as found by the District Court (R. 67-79), may be summarized sufficiently for present purposes as follows:²

At and during all times hereinafter mentioned, the taxpayer was and now is a resident of the State of Oregon. During the taxable year ended February 28, 1943, and prior thereto, he was engaged in the business of operating a cannery in the State of Oregon, and another cannery in the State of Washington. During the taxable years ended February 29, 1944, and February 28, 1945, he was engaged in the business of acquiring, owning, expanding, equipping and leasing food processing plants, and providing, through guarantee and otherwise, adequate financing of the operations of such plants; and such business during those times

(2) The facts pertaining to the other two issues, not appealed herein, and other detailed facts, figures, etc., not important to a determination of the issue, have been omitted from the statement of facts for the sake of brevity.

was regularly carried on by the taxpayer for profit.³ (R. 67-68.)

At and during all the times hereinafter mentioned the taxpayer kept his books of account and made his income tax returns on the accrual and fiscal year bases, his fiscal year beginning on the first day of March and ending on the last day of the following February of each calendar year. (R. 68-69.)

On or about June 15, 1944, the taxpayer filed with the Collector an amended individual income tax return (Form 1040) for the taxable year ended February 28, 1943, evidencing a total income tax liability in the sum of \$141,722.80 for that year; and also an individual income and victory

(3) We object to this and the other ultimate findings of fact, and the District Court's conclusions in respect thereto (R. 79-81, paragraphs II, III, V, and VIII), to the effect that the taxpayer was engaged in the business of financing cannery corporations, and that his advancements and guarantees of their obligations to them constituted debts rather than capital investments (R. 72, 79-80). We submit and show hereinafter that these findings and conclusions were erroneously drawn from various subordinate facts and are not supported by the undisputed primary facts, and that the conclusions drawn therefrom are contrary to the undisputed facts, the law and the authorities, as set forth in our statement of points to be relied on upon appeal (R. 87-89), and are therefore subject to revision, correction and reversal upon appeal by this Court. (See also fns. 5-9, 13 and 14, *infra*.)

tax return (Form 1040) for the taxable year ended February 29, 1944, evidencing a combined income and victory tax liability in the sum of \$152,619.84 for the taxable period beginning March 1, 1942, and ended February 29, 1944. Pursuant to such returns, the taxpayer paid to the Collector the sums of \$76,297.91 and \$1,394.59, \$76,297.91, and \$214.53 on or about October 8, 1943, February 19, 1944, and March 22, 1945, respectively. Those payments fully paid all the tax liability of the taxpayer as evidenced by such tax returns. (R. 69.)

On or about April 21, 1945, the taxpayer filed with the Collector his individual income tax return (Form 1040) for the taxable year ended February 28, 1945,⁴ evidencing no tax liability for that taxable year but rather a net loss in the sum of \$127,052.35, incurred in the taxpayer's above-mentioned business.⁵ (R. 69.)

During the taxable year ended February 28, 1945, Spencer Dehydrator, Inc., of Lebanon, Oregon, an Oregon corporation, owed the taxpayer the sum of \$61,115.48, on account of accounts payable of this corporation which the taxpayer had previously guaranteed and paid, and on ac-

(4) Reference hereinafter to the taxable years 1943, 1944 and 1945 shall be understood to mean the taxable years ended on the last day of February of those years.

(5) We likewise object to this finding in respect of "the taxpayer's above-mentioned business", for the same reasons stated in fn. 3, *supra*.

count of notes payable of the corporation upon which the taxpayer was surety and which he paid. Also during that taxable year the Spencer Packing Company of Yakima, Washington, a Washington corporation, owed the taxpayer the sum of \$33,966.02 on account of unpaid rent, sums advanced by the taxpayer to that corporation to pay promissory notes of the corporation upon which the taxpayer was surety which were used by it to pay the notes, lug boxes rented to the corporation by the taxpayer and not returned by it to him because they had become broken, and money belonging to him and collected but not paid over to him by the corporation. The sums owed the taxpayer by those corporations were unpaid balances on open accounts receivable of the taxpayer and not open accounts payable of the corporations, and were debts which arose in the course of the taxpayer's above business but were not contributions to the capital of those corporations or to the capital of either of them.⁶ Each of the corporations was completely liquidated within the taxable year ended February 28, 1945, and since February 15th of that year neither of them has engaged in any business or had any income or assets. Prior to the liquidation of those corporations, they were engaged

(6) We likewise object to this finding in respect of, "The sums * * * were debts which arose in the course of the taxpayer's above business but were not contributions to the capital of those corporations or to the capital of either of them", for the reasons stated in fn. 3, *supra*.

in the business of food processing. Each and the whole of the above-mentioned debts became worthless in that taxable year, and the loss sustained by the taxpayer from the worthlessness thereof was incurred by him in such business and was attributable to the operation of such business regularly carried on by the taxpayer.⁷ (R. 71-72.)

In the taxpayer's return for the taxable year 1945, a deduction was taken for bad debts in the amount of \$107,567.51, which was for the two debts mentioned above. At the time the return was made, the taxpayer's books showed that the amount owed him by the Spencer Dehydrator Corporation was \$73,601.49, which, together with the other sum of \$33,966.02 owed him by the Spencer Packing Company, made up the aggregate amount of \$107,567.51. The sum of \$73,601.49 represented the balance due the taxpayer after applying all available credits against his account with Spencer Dehydrators, Inc., except that there was erroneously included in such balance the sum of \$223.21 which was due and owing by the taxpayer during that taxable year on account of taxes on real and personal property. Such taxes, however, were against the Dehydrator plant which the taxpayer was renting to that corporation in the course of his business. One of the credits to Spencer

(7) We likewise object to this finding in respect of "the operation of such business regularly carried on" by the taxpayer, for the reasons stated in fn. 3, *supra*.

Dehydrator, Inc., was for its account against the Commodity Credit Corporation, which account the taxpayer had taken over. Subsequent to the filing of the return and the refund claim mentioned hereinafter, an audit of that account was made by representatives of the Commodity Credit Corporation, and it was determined thereby that the Commodity Credit Corporation owed \$12,262.82 on that account, in addition to the amount shown on the books of Spencer Dehydrators, Inc., on February 15, 1945, when the account was taken over as a credit by the taxpayer. Such sum was entirely earned by Spencer Dehydrator, Inc., which was entitled to receive it from the Commodity Credit Corporation prior to February 15, 1945. It was applied as a further credit and, with the above taxes, it reduced the taxpayer's bad debt against Spencer Dehydrator, Inc., from \$73,601.49 to \$61,115.46 as specified above, and thereby reduced his total bad debts for the taxable year from \$107,567.51 to \$95,081.48. (R. 72-74.)

The taxpayer's gross income from his business for the taxable year 1945 was \$33,562.28. He took business deductions for that year in the sum of \$17,217.72, about which there is no dispute. This amount, together with the above two bad debts of \$95,081.48, taxes of \$223.21, and depreciation of \$31,617.89, gave the taxpayer business deductions for that year in the aggregate sum of \$144,140.33. His net loss attributable to the operations of his above

business⁸ for that taxable year was \$110,578.05. (R. 75.)

During the taxable year 1945, the taxpayer sold property which had been held by him for more than six months and realized a gain therefrom in the total sum of \$17,141.39. There are no other gains, losses or deductions to be taken into account in computing the taxpayer's "net operating loss" for that taxable year, in accordance with the provisions of Section 122 of the Internal Revenue Code. The taxpayer sustained a "net operating loss" for that year, and a "net operating loss carry-back" for the taxable years 1943 and 1944, within the meaning of Section 122, in the sum of \$93,436.66 which was incurred in and was attributable to the operation of the above business regularly carried on by him.⁹ (R. 75.)

Prior to having sustained the above-mentioned "net operating loss carry-back" for 1943 and 1944 (R. 75), and by April 21, 1945 (when he filed his 1945 tax return (R. 69)), the taxpayer had paid to the Collector the total amount of \$152,619.84 on account of his combined income and victory tax liability for the taxable period ended February 29, 1944, as shown above (R. 69). He overpaid his

(8) We likewise object to this finding in respect of "the operations of his above business" for the reasons stated in fn. 3, *supra*.

(9) We likewise object to this finding in respect of "the operation of the above business regularly carried on by him", for the reasons stated in fn. 3, *supra*.

income and victory tax liability for that taxable period in the sum of \$78,659.03, and the Collector has not refunded such amount or any part thereof to the taxpayer.¹⁰ (R. 78.)

On or about April 21, 1945, the taxpayer filed with the Collector a claim for the refund of \$93,565.04, which was based on the ground presented in the complaint herein (R. 2-42), namely, that he is entitled to the "net operating loss carry-back", and that the recomputation of his income and victory taxes for the taxable period ended February 29, 1944, including the "net operating loss carry-back", results in an overpayment of his income and victory taxes for that period. More than six months elapsed from the filing of the claim to the date of the filing of this action, and no notice of allowance or disallowance thereof has been received by the taxpayer from the Commissioner of Internal Revenue. (R. 78.)

Upon the basis of the foregoing facts the District Court held that the taxpayer was engaged in the business regularly

(10) We object to this finding, of course, as being an erroneous conclusion drawn from the several adverse findings of fact which we consider wrong and contrary to the undisputed facts, the statute and the decisions, as herein-after shown in our argument.

carried on by him of guaranteeing the operations of his three wholly-owned corporations during the taxable years 1944 and 1945, and that therefore he was entitled to carry

back to the taxable year 1944 the net operating losses alleged to have been suffered in 1945, within the meaning of Sections 23 (k) (4) and 122 of the Internal Revenue Code (Appendix, *infra*). (R. 79-80.) The District Court thereupon entered judgment, with costs, in favor of the taxpayer (R. 83-84), from which the Collector and the United States, as interpleader, appealed to this Court for review (R. 85).

STATEMENT OF POINTS TO BE URGED

The District Court erred (R. 87-89):

1. In finding and concluding that the taxpayer was, during the taxable year, engaged in the trade or business, regularly carried on by him, of financing, acquiring, owning, expanding, equipping and leasing food processing plants.
2. In finding and concluding that the sums advanced by the taxpayer to or on behalf of the corporations here involved, the Spencer Dehydrators, Inc., of Lebanon, Oregon, and the Spencer Packing Company of Yakima, Washington, constituted bad debts and did not constitute capital investments by the taxpayer in those corporations.
3. In concluding that during the taxable years ended February 28, 1943, February 29, 1944, and February 28, 1945, the taxpayer was engaged in a business regularly carried on by him within the meaning of Section 23 (k) (4) and Section 122 (d) (5) of the Internal Revenue Code.
4. In concluding that the sums of \$61,115.46 and

\$33,966.02 were owed to the taxpayer by the Spencer Dehydrators, Inc., and the Spencer Packing Company of Yakima, and that such amounts were debts which became worthless within the taxable year ended February 28, 1945, and concluding that the taxpayer incurred a loss in a business regularly carried on by him during that period in the total sum of \$95,081.48, from worthless debts, within the meaning of Section 23 (k) of the Internal Revenue Code.

5. In concluding that the taxpayer was entitled to a net operating loss carry-back, within the meaning of Section 122 of the Internal Revenue Code, for the taxable period begun March 1, 1942, and ended February 29, 1944, in the sum of \$93,436.66.

6. In granting judgment in favor of the taxpayer and against the United States to the extent that the judgment was based on the allowance of the aforementioned net operating loss carry-back under Section 122 of the Internal Revenue Code.

SUMMARY OF ARGUMENT

The taxpayer is not entitled to carry back and deduct from the income of the taxable year 1944 the losses allegedly suffered in 1945 for the right to such carry-back is limited by the statute to losses "attributable to the operation of a trade or business regularly carried on by the taxpayer". The District Court's findings and conclusions to the con-

trary are directly opposed to the undisputed facts showing that the taxpayer was not engaged in such business, generally, within the meaning of the terms of the statute and the decisions. The taxpayer, the sole stockholder of his three cannery corporations, financed and guaranteed only *their* operations and obligations, respectively, not those of other canneries or corporations generally. Therefore, he was not engaged in carrying on such business regularly. While the taxpayer, as sole stockholder, completely controlled and dominated the three corporations, their businesses were not *his* businesses. Accordingly, it follows that the losses resulting from the several canneries' liquidation and their consequent inability to repay the taxpayer were merely isolated capital transactions which were not attributable to the operation of a trade or business regularly carried on by the taxpayer, within the meaning of the statute and the controlling decisions.

The taxpayer's advances and extension of his credit to his three wholly-owned cannery corporations represented capital contributions and not bad debts owed him by them. Without his meeting the burden of proving that he was regularly engaged in the above-mentioned business *and* that the guaranteed corporate obligations and accrued rentals represented bad debts and not capital investment, the taxpayer cannot prevail. The District Court's findings and conclusions to the contrary in this respect are likewise directly against the undisputed facts, the law, and the de-

cisions, showing that the items in question represented capital contributions. The taxpayer's activities on behalf of the canneries merely thereby arranged and provided for the necessary capital for those purposes, and that constitutes capital contributions, under the statute and authorities. The loss which the taxpayer seeks to carry back and charge against income of the taxable year, therefore, is a capital investment loss which does not meet the requirements of the statute in respect of carry-back deductibility.

ARGUMENT

THE TAXPAYER IS NOT ENTITLED TO CARRY BACK AND DEDUCT FOR THE TAXABLE YEAR 1944 THE NET OPERATING LOSS ALLEGED TO HAVE BEEN SUFFERED IN 1945.

The question for decision here is whether the taxpayer is entitled to carry back and deduct from gross income for the taxable year 1944 his net operating losses alleged to have been sustained in 1945, under the carry-back provisions of Section 122 of the Internal Revenue Code (Appendix, *infra*). The taxpayer contended in the court below and the District Court decided (R. 79-82), that he could properly do so under the terms of the statute, and that therefore he is entitled to recover herein. We submit, however, that the District Court's findings and holdings to such effect are erroneous as not being supported by the undisputed facts,

and are contrary to the provisions of the statute and the controlling authorities.

The statute permits taxpayers to carry back and deduct for any two preceding taxable years begun after January 1, 1941, net operating losses for the current taxable year begun after December 31, 1941, such carry-backs being limited to losses attributable to the operation of a trade or business regularly carried on by the taxpayer. Section 122 (a) to (e), inclusive, of the Internal Revenue Code. Section 122 (d) (5), however, provides that deductions otherwise allowed by law which are not attributable to the operation of a trade or business regularly carried on by an individual taxpayer (other than a corporation) shall be allowed only to the extent of the amount of the gross income which is not derived from such trade or business. Hence in order to prevail, it is incumbent upon the taxpayer to establish (a) that his activities in financing and guaranteeing the obligations of only his three wholly-owned and controlled cannery corporations during the taxable year constituted "the operation of a trade or business regularly carried on" by him, within the meaning of Section 122 (d) (5); and also (b) that his advancements and guaranteeing the obligations and accrued rentals of those corporations, by extending his credit and endorsing their notes in order to have the necessary operating capital to carry on their businesses, represented ordinary bad debts and not con-

tributions to capital.¹¹ (R. 108, 109.) The taxpayer, however, has failed to prove either proposition.

A. The taxpayer's financing only his own corporations instead of cannery or other corporations generally, did not constitute the operation of a trade or business regularly carried on by him.

A short resume' of the facts will readily show that the taxpayer was not engaged in the business, generally, of

(11) It is well established that deductions are matters of legislative grace and the taxpayer must show that he comes clearly within the statute. *New Colonial Co. v. Helvering*, 292 U. S. 435. In order to recover, the taxpayer must establish *both* of the conditions prescribed in Section 122 for they are conjunctively stated in the statute. The taxpayer, however, has not succeeded in doing this, as we show hereinafter. Moreover, since the taxpayer is seeking to carry back and deduct net operating losses of the year 1945 against income of the taxable year 1944, he is thereby in effect making a claim in the nature of an exemption from tax under Section 122 to the extent of avoiding taxes otherwise due and payable for the taxable year, and therefore he cannot prevail for, as we shall show later, he has failed to bring himself literally within the terms of the statute allowing it. *Helvering v. Northwest Steel Mills*, 311 U. S. 46, 49; *United States v. Stewart*, 311 U. S. 60, 71; *White v. United States*, 305 U. S. 281, 292; *New Colonial Co. v. Helvering*, *supra*; It is settled that exemption from taxation should not rest upon implication. *United States v. Stewart*, *supra*, p. 71; *U. S. Trust Co. v. Helvering*, 307 U. S. 57, 60.

financing and guaranteeing the obligations of even cannery, much less other, corporations generally. The net operating losses sought to be carried back from 1945 and deducted for the taxable year 1944 are alleged to have been suffered because of the taxpayer's guarantees to pay the obligations of two of the corporations wholly owned by him which had been formed after the taxpayer had been in the cannery business for many years. He formed these two corporations—and also another which is not involved here—just prior to the taxable year involved in order to operate his canneries on a percentage-of-production basis. Prior thereto he had obtained growers' contracts which were assigned to the corporations which had no working capital or credit. The taxpayer agreed in the leases of the plants to the corporations to guarantee their obligations. The two corporations were not successful and they were liquidated. The taxpayer made advancements to them which were carried on their books as accounts payable to the taxpayer. Upon liquidation the taxpayer satisfied their outstanding obligations and it is this amount and the advancements which he claims as a carry-back loss. On these facts the taxpayer attempted to show below, and the District Court found (R. 67-68, 72, 75) and held (R. 79-80), that the taxpayer was in the business of financing canneries and thereby sustained the claimed carry-back loss, within the meaning of Section 122. The court below so found and held despite the

fact that the record shows that, according to the taxpayer's own testimony (R. 158-161), the only corporations which he endeavored to and ever did finance were his own three completely-owned and dominated canneries (R. 153-154), of which he was the sole stockholder (barring "three or four qualifying shares" held by others) (R. 108, 129, 154-155), and that he had never financed any other corporations (R. 153-154).

The primary facts relative to this issue are not in dispute. (R. 109.) They show that the taxpayer did finance, by the extension of his credit, his three wholly-owned canneries operated by him as president and chairman of the board of directors (R. 104-105, 121, 123), as the court below found (R. 68). However, the District Court's ultimate finding and conclusion that the taxpayer was engaged in the business of financing and guaranteeing the obligations of cannery corporations, generally, and therefore he was entitled to the net operating loss carry-back (R. 68, 79-80), find no support in the undisputed facts and the evidence of record, or in the statute and controlling decisions. The undisputed facts show that the taxpayer financed only his own three cannery corporations (R. 104, 133-135), and no others (R. 153-154), in order "to protect" his stock in those corporations (R. 157-158). There is no evidence whatever to show that he held himself out to the public generally as a banker, financier, or otherwise engaged in carrying on

the business of financing cannery or other corporations, generally, or that he ever promoted and financed any corporations other than his own three wholly-owned canneries. The evidence shows that he did not do so. (R. 153-154.) It also shows that the taxpayer, as sole stockholder, expanded his credit and invested the money by financing the three cannery enterprises (R. 123), which were wholly without assets or capital otherwise (R. 105, 161), in order to make them operate and pay him the lease money (R. 104), and that when they turned out to be unprofitable enterprises (R. 105-106, 125, 141), either from his standpoint as sole stockholder or from that of receiving rentals therefrom, he "sold out" the canneries and took the losses¹² (R. 104, 158-159, 160-161).

Thus, the District Court's adverse findings and conclusions, heretofore objected to, are not supported by any real evidence, much less *substantial* evidence, the preponderance of the evidence and the undisputed facts being the other way, and consequently, without the necessity of this Court's weighing the evidence at all, they should be set aside and

(12) In this connection, the taxpayer testified on cross-examination substantially as follows (R. 158-161): In order to make the three canneries successful in their operations, the taxpayer expanded his credit and invested that money to make the enterprises work because that would be financially beneficial for him. (R. 158.) Otherwise they would not have been able to pay the taxpayer the lease money and

reversed by this Court as a matter of law.¹³ As the court stated in *Cohen v. Commissioner*, 148 F. 2d 336, 337 (C.C.A. 2d), apropos of this, even though that conclusion was directly contrary to the testimony of the taxpayer's two witnesses, nevertheless—

he would have received no other return from the corporations. He agreed in the leases to finance the corporations. Finally, he decided that they were not profitable enterprises, either from his standpoint as sole stockholder or from that of receiving the rentals, and therefore he "sold out" the corporations. The taxpayer was "apparently" financially able to operate the canneries himself, independently of the corporations. (R. 159.) The three corporations, however, were operating under agreements with the banks, guaranteed by the taxpayer, because he did not have sufficient money to finance the companies himself, independently of the banks. When he organized the companies he knew he had to raise the necessary funds somehow in order to get their operations started and therefore he extended his credit for that purpose, the corporations not having sufficient independent credit of their own to borrow the necessary money from the banks in order to have started operations. (R. 160.) They did not have the necessary assets for that purpose upon incorporation, and therefore the only possible way for them to get started was for the taxpayer to assist them in the financing of it. (R. 161.)

(13) As stated in several footnotes under the statement of facts, *supra*, we object to the District Court's erroneous adverse findings and conclusions, drawn from various subordinate facts, as being unsupported by the undisputed primary facts and contrary to the decisions and statute. (See fns. 3 and 5-9, *supra*.)

* * * as we suggested in *Golden Eagle Farm Products, Inc.*, v. *Approved Dehydrating Co.*, 2 Cir. 147 F. 2d 359, footnote 1, if the uncontradicted witness rule applies at all when there is no jury, it must yield when there are facts which even indirectly may give rise to inferences contradicting the witness. In the case at bar such inferences may be drawn from undisputed facts;
* * *

The Government's exceptions to the conclusions of law of the court below and its refusal to reach other conclusions in harmony with the undisputed facts, as requested, raises a substantial question of law—whether the District Court's verdict was wholly without evidence to sustain it—and consequently its general verdict is not conclusive. Since the undisputed facts show that the verdict below was without evidence to sustain it, therefore, it is proper for this Court to reverse. While findings of fact, of course, should not be disturbed if supported by substantial evidence, nevertheless it is settled that erroneous fact inferences will be set aside and corrected when not supported by the facts found, or if wrong inferences were drawn, as herein. *McCaughn v. Real Estate Co.*, 297 U. S. 606, 608. Moreover, the District Court's findings of fact and conclusions—that the taxpayer was engaged in the business of cannery financing regularly carried on by him—used the words of the statute, and its conclusions involve the meaning of the words found in the statutory provisions. Hence, they are questions of law, the decision of which is unembarrassed by any disputed ques-

tion of fact or any necessity to draw an inference of fact from the basic findings. Consequently, the conclusion of the District Court does not foreclose their decision by this Court. Cf. *Trust of Bingham v. Commissioner*, 325 U. S. 365, 371; *Rassenfoss v. Commissioner*, 158 F. 2d 764, 765-766 (C.C.A. 7th). Hence the District Court's application and use of the statutory words in its adverse findings of fact and the meaning thereof in its conclusions, is reviewable. Moreover, the District Court's finding that the taxpayer was engaged in such business was a conclusion, and it is settled that the findings of fact should not include conclusions of law. *Jackson v. United States*, 230 U. S. 1, 18.

The District Court plainly misinterpreted the words—"the operation of a trade or business regularly carried on by the taxpayer"—of the statute (Section 122 (d) (5)), and failed to apply and ignored the rules laid down in the controlling decisions, cited and relied upon by the Government in the court below. Thus, *Burnet v. Clark*, 287 U. S. 410, relied upon below, is a case in all material respects directly in point and is controlling here. There the taxpayer was the major stockholder, active head and president of the Bowers Southern Dredging Company. The corporation needed credit and the taxpayer endorsed the company's obligations to the bank. The assets of the corporation went into the hands of its creditors and in 1922 a new corporation was formed. The taxpayer was, in 1921, required to pay

\$68,000 on the endorsements. The Commissioner disallowed a carry-over loss in 1923, claimed under Section 204 (a) and (b) of the Revenue Act of 1921, c. 136, 42 Stat. 227 (statutory provisions similar to those here involved), because the loss did not result from the operation of a "trade or business regularly carried on by the taxpayer." The Board of Tax Appeals sustained the Commissioner's determination (19 B.T.A. 859), the Court of Appeals of the District of Columbia reversed (59 F. 2d 1031), and the Supreme Court reversed the appellate court in favor of the Government, holding that the taxpayer was engaged as an officer in operating and regularly carrying on a dredging business and not the business of financing companies. The Court, quoting approvingly from the Board's opinion in that case, stated (287 U. S. 410, 413):

"In order for the losses here involved to be deductible in determining taxable income for 1923, they must be net losses resulting from the operation of a trade or business regularly carried on by the petitioner and not from isolated and occasional transactions . . .

"With respect to the loss of \$68,000 resulting from the petitioner's endorsement of the Bowers Company notes, he testified that in endorsing the notes he was seeking to protect his investment in its stock. *Aside from endorsing an undisclosed number of notes of this company there is nothing in the record to indicate that acting as endorser or guarantor constituted a business or trade with the petitioner.* So far as the record shows these were the only notes ever endorsed by the petitioner

for the Bowers Company or for any other company or person. From the facts in the case we are of the opinion that *the loss did not result from the operation of a trade or business regularly carried on by the petitioner but resulted from isolated or occasional transactions . . .* [Italics supplied.]

The Court thereupon concluded as follows (p. 415):

"The respondent was employed as an officer of the corporation; the business which he conducted for it was not his own. There were other stockholders. And in no sense can the corporation be regarded as his alter ego or agent. He treated it as a separate entity for taxation; made his own personal return and claimed losses through dealings with it. He was not regularly engaged in endorsing notes, or buying and selling corporate securities. The unfortunate endorsements were no part of his ordinary business, but occasional transactions intended to preserve the value of his investment in capital shares." [Italics supplied.]

Thus the only difference between the two cases is the immaterial one that the taxpayer there, as the principal stockholder, president and active head of the corporation, financed the *single* corporation by endorsing its obligations to the bank, whereas the taxpayer herein, as sole stockholder, did the same thing in connection with his three cannery corporations. We doubt that the taxpayer would contend that whether one or three corporations were involved, would make any difference in the result under the same factual situation. Moreover, substantially all the principal

arguments made by the taxpayer herein were likewise presented and overruled by the Supreme Court in that case.

Likewise, *Dalton v. Bowers*, 287 U. S. 404, contains a similar factual situation. There the taxpayer organized a corporation in 1917 which, accordingly to his testimony, was to develop and improve his patented inventions. In 1924 the corporation became hopelessly insolvent and in 1925 it passed out of existence. In 1923 and 1924 the taxpayer claimed large deductions on account of bad debts due from the corporation. In his 1925 return the taxpayer claimed a deduction of \$395,000 which represented the full amount which he had paid for all the stock of the corporation. The theory on which the deduction was claimed in 1925 was that when the stock of the corporation became worthless in 1924 the taxpayer sustained a net loss in his trade or business which was deductible from 1925 income under Section 206 (a) and (b) of the Revenue Act of 1924, c. 234, 43 Stat. 253 (similar to the statutory provisions involved herein). In support of that theory, the taxpayer contended that the corporate entity constituted a part of his individual trade or business which was not merely that of inventing but included the exploiting of his inventions and developing and selling them through corporations organized for that special purpose. The Court, in holding that the loss sustained in 1924 was not a statutory net loss, pointed out that whether theoretically valid or not, the taxpayer's

argument rested on assumptions out of harmony with the facts disclosed by the record; the taxpayer was not regularly engaged in the business of buying and selling corporate stocks; the general rule for tax purposes is that a corporation is an entity distinct from its stockholders; and the circumstances there were not so unusual as to create an exception. The Supreme Court quoted approvingly from the appellate court's opinion, in respect of the taxpayer there who "paid the debts of the corporation" which he "dealt with * * * as an entity", as follows (p. 407):

"There is no justification for saying that the business of the corporation was that of the appellee. During the period the appellee dealt with the corporation as an entity. When he paid the debts of the corporation, he drew on his personal account in favor of the corporation's account and this made the corporation his debtor. Separate tax returns were filed by the corporation and by the appellee. * * * *The loss now sought to be deducted was an investment which he made in the corporation and did not occur in the operation of the trade or business regularly carried on by the appellee . . .*" [Italics supplied.]

The Court then continued (pp. 409-410):

"Dalton was not regularly engaged in the business of buying and selling corporate stocks. He organized the Manufacturing Corporation and took over all its shares with the intention of selling them at a profit. He treated it as something apart from his ordinary affairs, accepted credits for salaries as an officer, claimed loss to himself because of loans to it which

had become worthless, and caused it to make returns for taxation distinct from his own. *Nothing indicates that he regarded the corporation as his agent with authority to contract or act in his behalf. Ownership of all the stock is not enough to show that creation and management of the corporation was a part of his ordinary business.* Certainly, under the general rule for tax purposes a corporation is an entity distinct from its stockholders, and the circumstances here are not so unusual as to create an exception.” [Italics supplied.]

In *Deputy v. duPont*, 308 U. S. 488, the Court denied a deduction for carrying charges, incurred by the taxpayer on sales of stock made to assist his corporation and preserve his investment in the corporation, on the ground that the taxpayer was not engaged in the business of trading in securities. The Court, following *Burnet v. Clark, supra*, said (pp. 493-494):

“In the first place, the payments in question do not meet the test enunciated in *Kornhauser v. United States*, 276 U. S. 145, since they proximately result not from the taxpayer’s business but from the business of the *duPont Company*. The original transactions had their origin in an effort by that company to increase the efficiency of its management by selling its stock to certain of its key executives. The respondent undertook to furnish the necessary stock only after the company had been advised that it could not legally do so. In that posture of the case these payments are no more deductible than were the payments made by the stockholder in *Burnet v. Clark, supra*, as a result of his endorsements of the obligations of his corporation. Those

payments were disallowed as deductions from his gross income though they arose out of transactions which were intended to preserve his investment in the corporation. Similar payments were disallowed in *Dalton v. Bowers*, 287 U. S. 404." * * * [Italics supplied.]

Mr. Justice Frankfurter, in a concurring opinion in the *duPont* case, *supra*, stated (p. 499) that—

"‘carrying on any trade or business,’ within the contemplation of Section 23 (a), involves holding one’s self out to others as engaged in the selling of goods or services." * * *

To the same effect, see *Van Dyke v. Commissioner*, 23 B.T.A. 946, affirmed *per curiam* by this Court, 63 F. 2d 1020, and also affirmed *per curiam* by the Supreme Court, 291 U. S. 642, rehearing denied, 291 U. S. 650 (both on the authority of *Burnet v. Clark*, *supra*, and *Dalton v. Bowers*, *supra*); also *Watson v. Commissioner*, 124 F. 2d 437, 439 (C.C.A. 2d) (where the court stated that "Even when one man owns all the stock, he and his corporation will usually be treated as separate legal entities for tax purposes"); *Stephenson v. Commissioner*, 101 F. 2d 33 (C.C.A. 6th), certiorari denied, 307 U. S. 647; and *Gruver v. Helvering*, 70 F. 2d 292 (App. D.C.). In the *Van Dyke* case, both this Court and the Supreme Court held, under facts similar to those herein, that the taxpayer’s advances to, and activities in connection with, the timber corporation there did not constitute his trade or business regularly

carried on but an investment in the company for credit. Consequently, it was held that the loss resulting from the failure of the company in the taxable year was not incurred in *his* trade or business, and therefore it could not be carried forward and deducted from his income in later years.

Several cases, such as *Kittredge v. Commissioner*, 88 F. 2d 632 (C.C.A. 2d); *Averill v. Commissioner*, 20 B.T.A. 1196, and *Conrades v. Commissioner*, 21 B.T.A. 213, for example, were cited and relied upon by the taxpayer in the court below but they are distinguishable on their facts and of no help to him here. Thus, the *Kittredge* case held that the basis for determining gain or loss on the sale of a winery, in 1931, should be adjusted for depreciation sustained from the property so acquired, in 1919, even though it was not used by the taxpayer or rented from 1922 to the time of the sale in 1931. The court was of the opinion (p. 634) that the phrase "used in the trade or business" in the section of the statute permitting deductions for depreciation should be read as equivalent to "devoted to the trade or business". That case did not involve the issue presented here. *Averill v. Commissioner*, *supra*, involved a taxpayer who promoted and devoted the usual business hours each day to the affairs of many diverse enterprises (approximately 35 corporations), operating each business venture through a corporation instead of as a personal venture and maintaining an office and a number of employees to carry

on such businesses. The loss sustained from the failure of one of the corporations, in 1922, was held to have resulted from the taxpayer's business and therefore properly considered in computing the amount of the net loss which could be carried forward and applied against the income of 1923 and 1924. That case, therefore, had all the statutory indicia of the operation of one's trade or business during the taxable year. However, that case (decided in 1930) was, like other cases relied upon by the taxpayer below, decided *before* the Supreme Court decided *Burnet v. Clark*, and *Dalton v. Bowers* (*both supra*) the other way in 1932, and therefore it is of doubtful value or effect herein. Moreover, such cases as *Conrades v. Commissioner*, *supra*, involved entirely different factual situations, the taxpayer there, for instance, having been actively engaged in the loan business for many years. None of the cases cited by the taxpayer below has any effective application to the facts herein or gives aid to the taxpayer.

B. The taxpayer's advancements and extension of his credit to his three wholly-owned corporations represented capital investments.

The taxpayer contended below that his advancements and obligations guaranteed to the three cannery corporations did not represent capital contributions but debts due him which became worthless during the taxable year 1945,

and therefore such net operating loss incurred in his business may properly be carried back and applied against income for the taxable years 1943 and 1944, under Sections 23 (k) and 122 of the Internal Revenue Code (Appendix, *infra*).

We have already shown under subheading A that the losses in question were "not attributable to the operation of a trade or business regularly carried on by the taxpayer", within the meaning of Section 122 (d) (5) and the controlling authorities. If more be necessary, however, we submit that the taxpayer has the burden of establishing both questions mentioned above as determinative of the issue presented herein since they are conjunctive in character—that is, whether the taxpayer's activities in guaranteeing the obligations of the three cannery corporations constituted a trade or business regularly carried on by him, *and* whether the guaranteed corporate obligations and accrued rentals represented bad debts and not contributions to capital. (R. 108, 109.) The taxpayer has met neither of these requisite burdens. If, however, it be considered that, contrary to the authorities cited above, the taxpayer's activities in making the advancements to and guaranteeing the obligations of only *his* three cannery corporations, amounted to his being a banker or financier operating and carrying on such businesses regularly, within the meaning of Section

122 (d) (5), we submit that he is still not entitled to prevail for the reason that the advancements or other items sought as carry-back deductions for the taxable year constituted in fact capital investments and not bad debts deductible under the statute.

The court below found that the sums owed the taxpayer by the three cannery corporations were unpaid balances on open accounts receivable of the taxpayer and were debts which arose in the course of his business, and not contributions to capital. (R. 72.) It therefore concluded that the taxpayer incurred the losses in his business so carried on because those debts became worthless in the taxable year 1945, within the meaning of Section 23 (k), to the end that he is entitled to the claimed net operating loss carry-back for the taxable years 1943 and 1944, under Section 122.¹⁴ (R. 80.) The taxpayer testified that he was in the business of financing his own corporations (R. 120-121, 123, 130, 151, 156, 164), but that he had never financed any other corporations of which he did not own all the stock (R. 153-154); and he contended below that the obli-

(14) We likewise objected to these findings and conclusions under the statement of facts, *supra*. See fns. 3, 5-9, and 13, *supra*.

gations satisfied by him constituted debts of the three cannery corporations and not capital investments. We submit, however, that the District Court's findings and con-

clusions to such effect are not supported by the undisputed facts and are contrary thereto and to the authorities, and that they are therefore reviewable and should be reversed for the same reasons as stated under subheading A, *supra*, in respect of the other adverse findings and conclusions objected to,¹⁵ as heretofore shown.

It clearly is not important, we submit, that some of the items were carried on the corporations' books as debts due from them to the taxpayer (R. 104-105, 142-144), and that some of the obligations constituted unpaid and accrued rentals (R. 104, 124, 163), the entries of such transactions being merely evidential and not conclusive. *Gulf Oil Corp. v. Lewellyn*, 248 U. S. 71; *Doyle v. Mitchell Brothers Co.*, 247 U. S. 179. Considering substance and not mere form, as we must (*Gregory v. Helvering*, 293 U. S. 465; *Higgins v. Smith*, 308 U. S. 473; *Griffiths v. Commissioner*, 308 U. S. 355), and that mere legal form is not controlling (*Tyler v. United States*, 281 U. S. 497), it is apparent that the items in question (advancements, guaranteed obligations, etc.) constituted in effect contributions to capital and capital investment (*Dalton v. Bowers*, 287 U. S. 404, 407-408; *Burnet v. Clark*, 287 U. S. 410, 415). The record shows that it was necessary for the taxpayer to make advancements and to guarantee the obligations of his three cannery corporations in order to enable them, without other assets,

(15) See fn. 3, *supra*.

to operate at all (R. 158-161), and that by his endorsing the notes of those corporations and standing prepared to withstand any resulting losses, he merely thereby arranged and provided for the necessary capital for that purpose, and that constitutes capital contribution. *Dalton v. Bowers*, *supra*, pp. 407-408; *Burnet v. Clark*, *supra*, p. 415; *Janeway v. Commissioner*, 2 T. C. 197, affirmed, 147 F. 2d 602 (C.C.A. 2d); *Cohen v. Commissioner*, 148 F. 2d 336 (C.C.A. 2d); *American Cigar Co. v. Commissioner*, 66 F. 2d 425 (C.C.A. 2d), certiorari denied, 290 U. S. 699; *Corn Exchange National Bank & Trust Co. v. Commissioner*, 46 B.T.A. 1107.

In this connection, the Supreme Court stated in *Burnet v. Clark*, *supra*, p. 415, in respect of the taxpayer's endorsement of the corporation's obligations to the bank there, that they "were no part of his ordinary business, but occasional transactions intended to preserve the value of his investment in capital shares." (Italics supplied.) Likewise, in *Dalton v. Bowers*, *supra*, the Supreme Court quoted approvingly from the appellate court's opinion in respect of the taxpayer there, who "paid the debts of the corporation", as follows (pp. 407, 408):

"The loss now sought to be deducted was an investment which he made in the corporation and did not occur in the operation of the trade or business regularly carried on by the appellee . . .

* * * * *

"This taxpayer did not regard the business losses

of the Dalton Manufacturing Company as his loss. *The loss sustained by the appellee which he seeks to charge off is a capital investment loss.* The rule is well settled that the corporation will be looked upon as a legal entity . . ." [Italics supplied.]

To the same effect, see *Deputy v. duPont*, 308 U. S. 488, where the Court stated (p. 494) that "Those payments [made by the stockholder in the *Burnet v. Clark* and *Dalton v. Bowers* cases, *supra*, as the result of his endorsements of the obligations of his corporation] * * * arose out of transactions which were intended to preserve his investment in the corporation."

In *Janeway v. Commissioner*, *supra*, where the corporation gave the taxpayer, the sole stockholder, its notes for the advancements which he had made to it, the Circuit Court of Appeals for the Second Circuit held that such advancements to his wholly-owned corporation represented additional capital investments. In harmony therewith, the Tax Court there, apropos of the situation herein, had stated as follows (2 T.C. 197, 202-203):

"Though the advances made were, by the issuance of the notes, given the appearance of loans, the possibility of repayment was no stronger than the business and its possible success. No other money was paid in for stock, so that *the advances constituted the corporation's only source of working capital.*" [Italics supplied.]

Likewise the taxpayer's advances to his three corporations herein were made at the risk of the businesses and

represented the required capital not otherwise paid in by him, the sole stockholder, without which they could not have operated, and consequently they represented contributions to capital. To the same effect, is *Cohen v. Commission, supra*, where the court held (pp. 336-337) that no part of the advances to the corporation there was a loan but that the entire sum was a capital contribution under the facts therein.

The taxpayer's arrangement under the leases with his three cannery corporations whereby he furnished all the working capital (R. 104, 123, 157, 159) and eventually, upon their liquidation, withstood all the resulting losses, might well be considered to have constituted payments made under the contracts indemnifying the corporations against losses on their notes, thereby protecting the financial interests of the taxpayer, as sole stockholder, without giving him any claim, however, against the makers of the notes. Such payments, of course, are not allowable as deductions from gross income either as business expenses or losses as bad debts. *Hickey v. Chahoon*, 153 F. 2d 107 (C.C.A. 2d), certiorari denied, 328 U. S. 843; *Welch v. Helvering*, 290 U. S. 111; *Burnet v. Clark, supra*; *In re Park's Estate*, 58 F. 2d 965 (C.C.A. 2d), certiorari denied, 287 U. S. 645; and *Howell v. Commissioner*, 69 F. 2d 447 (C.C.A. 8th), certiorari denied, 297 U. S. 564 (where the court held that the payment by the taxpayer, a stockholder

of the bank, pursuant to a contract to indemnify the bank against losses on certain notes, gave the taxpayer no claim against the maker of the notes, and consequently that there was no basis for deducting the payment of the losses as a bad debt). To be sure, on this basis, the taxpayer's payments of the losses on the notes, etc., constituted contributions to capital investment and not losses on bad debts.

Accordingly, it is apparent that it would be necessary to ignore completely the plain words of the statute, the controlling decisions, and the realities of the case in favor of mere form in order to hold that the taxpayer's activities in financing his three wholly-owned cannery corporations constituted his business generally and regularly carried on, and also that the advancements to the corporations, the obligation of the endorsements on their notes, and the accrued rentals at the time of their liquidation, constituted bad debts and not capital investments. The facts show that the taxpayer wished, for reasons of his own, to operate his cannery plants through wholly-owned and controlled corporations, and that however he operated them he was obliged to finance them and therefore had to endorse their notes. There is no showing whatever that he ever held himself out as a banker, financier or investment broker providing such services for canneries or other corporations, generally. As already shown, the facts do show that he never did so with any other corporations than his three

canneries in which he owned the entire stock. (R. 153-154.) The taxpayer merely raised the funds on his own credit to operate his three canneries and restricted his activities and capital contributions directly to his own enterprises. These facts are clearly insufficient, under the authorities and the taxing statute, to establish that such activities constituted carrying them on regularly as his business of alleged banker, financier or otherwise, and thereby to bring his case within the statutory requirements entitling him to carry back and deduct from the income of the taxable year 1944 the net operating losses of the year 1945, within the meaning of Section 122 of the Internal Revenue Code.

Cases relied upon by the taxpayer below, such as *Edward Katzinger Co. v. Commissioner*, 44 B.T.A. 533, affirmed, 129 F. 2d 74 (C.C.A. 7th), for example, are distinguishable on their facts. There the court denied the bad debt deduction claimed for 1936, the year of the liquidation and dissolution of the subsidiary corporation to which the taxpayer had made advances in prior years. A consolidated return had been filed for 1933, and the court agreed with the Commissioner that to the extent that the taxpayer had obtained a deduction on the 1933 return for the operating losses of the subsidiary, the allowance of the deduction claimed for 1936 would result in a double deduction, which the court held (p. 75) was not allowable. That question is not involved here, directly or indirectly. Other cases of like

or similar import, cited and relied upon by the taxpayer below, are likewise of no help here.

CONCLUSION

The District Court's judgment in favor of the taxpayer is incorrect and directly contrary to the undisputed facts, the applicable statute, and the controlling judicial authorities. The judgment should therefore be set aside and reversed upon appeal by this Court, and judgment entered for the Collector of Internal Revenue and the United States.

Respectfully submitted,

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May, 1948.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) [as amended by Section 124 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] **BAD DEBTS.**—

(1) *General rule.*—Debts which become worthless within the taxable year; * * *

* * * * *

(4) *Non-business debts.*—In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

* * * * *

(s) [as added by Section 211 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862] **Net Operating Loss Deduction.**—For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under section 122.

(26 U.S.C. 1940, ed., Sec. 23.)

SEC. 122 [as added by Section 211 (b) of the Revenue Act of 1939, *supra*, and as amended by Sections 105 (e), 150 (e) and 153 (a), (b) and (c) of the Revenue Act of 1942, *supra*]. NET OPERATING LOSS DEDUCTION.

(a) *Definition of Net Operating Loss.*—As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) *Amount of Carry-Back and Carry-Over.*—

(1) *Net operating loss carry-back.*—If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(2) *Net operating loss carry-over.*—If for any taxable year the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-over for each of the two succeeding taxable years, except that the carry-over in the case of the second succeeding taxable year shall be the excess, if any, of the amount of such net operating

loss over the net income for the intervening taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such intervening taxable year without regard to such net operating loss and without regard to any net operating loss carry-back. For the purposes of the preceding sentence, the net operating loss for any taxable year beginning after December 31, 1941 shall be reduced by the sum of the net income for each of the two preceding taxable years (computed for each such preceding taxable year with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and computed by determining the net operating loss deduction without regard to such net operating loss or to the net operating loss for the succeeding taxable year).

(c) *Amount of Net Operating Loss Deduction.*—The amount of the net operating loss deduction shall be the aggregate of the net operating loss carry-overs and of the net operating loss carry-backs to the taxable year reduced by the amount, if any, by which the net income (computed with the exceptions and limitations provided in subsection (d) (1), (2), (3), and (4)) exceeds, in the case of a taxpayer other than a corporation, the net income (computed without such deduction), or, in the case of a corporation, the normal-tax net income (computed without such deduction and without the credit provided in section 26 (e)).

(d) *Exceptions, Additions, and Limitations.*—

The exceptions, additions, and limitations referred to in subsections (a), (b), and (c) shall be as follows:

(1) The deduction for depletion shall not exceed the amount which would be allowable if computed without reference to discovery value or to percentage depletion under section 114 (b) (2), (3), or (4);

(2) There shall be included in computing gross income the amount of interest received which is wholly exempt from the taxes imposed by this chapter, decreased by the amount of interest paid or accrued which is not allowed as a deduction by section 23 (b), relating to interest on indebtedness incurred or continued to purchase or carry certain tax-exempt obligations;

(3) No net operating loss deduction shall be allowed;

(4) Gains and losses from sales or exchanges of capital assets shall be taken into account without regard to the provisions of section 117 (b). As so computed the amount deductible on account of such losses shall not exceed the amount includible on account of such gains.

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions,

additions, and limitations specified in paragraphs (1) to (4) of this subsection.

(6) There shall be allowed as a deduction the amount of tax imposed by Subchapter E of Chapter 2 paid or accrued within the taxable year, subject to the following rules—

(A) No reduction in such tax shall be made by reason of the credit for income, war-profits, or excess-profits taxes paid to any foreign country or possession of the United States;

(B) Such tax shall be computed without regard to the adjustments provided in section 734; and

(C) Such tax, in the case of a consolidated return for excess-profits tax purposes, shall be allocated to the members of the affiliated group under regulations prescribed by the Commissioner, with the approval of the Secretary.

(e) *No Carry-Back to Year Prior to 1941.*—As used in this section, the term "preceding taxable year" and the term "preceding taxable years" do not include any taxable year beginning prior to January 1, 1941.

(26 U.S.C. 1940 ed., Sec. 122.)

In the United States
CIRCUIT COURT OF APPEALS
for the Ninth Circuit

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
Appellant,

v.

GRACE NEFF SPENCER, Executrix,
Appellee,
UNITED STATES OF AMERICA,
Interpleader-Appellant.

On Appeal from the District Court of the United States
for the District of Oregon.

BRIEF OF APPELLEE

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INDEX

| | Page |
|--|------|
| Opinion Below | 1 |
| Jurisdiction | 1 |
| Question Presented | 3 |
| Statutes Involved | 4 |
| Statement | 4 |
| Summary of Argument | 4 |
| Argument: | |
| A. Taxpayer was engaged in a business regularly carried on by him. The findings of the District Court shall not be set aside unless clearly erroneous | 7 |
| Appellants Fail to Sustain Burden | 9 |
| Trade or Business: A Question of Fact | 11 |
| The Test of Frequency and Continuity | 13 |
| The Profit Test | 17 |
| Similar Cases | 22 |
| Comments on Statements and Arguments of Appellants | 24 |
| B. Where the taxpayer makes advances which are an incident to his main business of acquiring, owning, expanding, equipping, and leasing food processing plants, and such advances subsequently become worthless, they must be taken into account in computing the net operating loss deduction | 29 |
| Cases Interpreting Section 23 (k) | 32 |
| C. Whether advances of the taxpayer represent obligations owed to him is primarily a matter of intent | 35 |
| Comments on Arguments Of and Cases Cited by Appellants | 41 |
| Conclusion | 48 |
| Appendix | 49 |

LIST OF CITATIONS

| | Page |
|--|------------------------|
| | <i>Decisions</i> |
| American Cigar Co. v. Commissioner, 66 F. 2d 425 (C.C.A. 2d, 1933) | 44 |
| Augustine v. Bowles, 149 F. 2d 93 (C.C.A. 9th, 1945) | 9, 30 |
| Averill, Glenn M., 20 B.T.A. 1196 (1930) | 22 |
| Boeing, Commissioner v., 106 F. 2d 305 (C.C.A. 9th, 1939) | 13 |
| Brodie Co. v. Hydraulic Press Mfg. Co., 151 F. 2d 91 (C.C.A. 9th, 1945) | 8 |
| Burnet v. Clark, 287 U.S. 410 (1932) | 15, 21, 34, 35, 44 |
| Campbell, Vincent C., P-H T.C. Par. 11.61 (1948) | 33, 34 |
| Cecil v. Commissioner, 100 F. 2d 896 (C.C.A. 4th, 1939) | 11, 17 |
| Cluett, 3rd, Robert, 8 T.C. 1178 (1947) | 32, 34 |
| Cohen v. Commissioner, 148 F. 2d 336 (C.C.A. 2d, 1945) | 41 |
| Conrades, Edwin H., 21 B.T.A. 213 (1930) | 22, 23 |
| Corn Exchange National Bank & Trust Co., 46 B.T.A. 1107 (1942) | 45 |
| Daily Journal Co. v. Commissioner, 135 F. 2d 687 (C.C.A. 9th, 1943) | 14, 20, 21 |
| Dalton v. Bowers, 287 U.S. 404 (1932) | 14, 15, 21, 34, 35, 44 |
| Deputy v. duPont, 308 U.S. 488 (1940) | 19, 20 |
| Doggett v. Burnet, 65 F. 2d 191 (App. D.C., 1933) | 18 |
| Ehrman v. Commissioner, 120 F. 2d 607 (C.C.A. 9th, 1941) | 14 |
| Ewing, Lucia Chase, P-H T.C. Memo. Dec. Par. 46,235 (1946) | 38, 39 |

LIST OF CITATIONS (Cont.)

| | Page |
|---|----------------|
| Fairbanks, Morse & Co. v. Harrison, 63 F. Supp. 495 (Ill., 1945) | 38 |
| Field, Commissioner v., 67 F. 2d 876 (C.C.A. 2d, 1933) | 18 |
| Foss v. Commissioner, 75 F. 2d 326 (C.C.A. 1st, 1935) | 14 |
| Gates v. General Casualty Co., 120 F. 2d 925 (C.C.A. 9th, 1941) | 8 |
| Gimbel, Daniel, 36 B.T.A. 539 (1937) | 38 |
| Glenmore Distilleries Co., Inc., 47 B.T.A. 213 (1942) | 38 |
| Gruver v. Helvering, 70 F. 2d 291 (App. D.C., 1934) | 21 |
| Hazard, Leland, 7 T.C. 372 (1946) | 23 |
| Heininger, Commissioner v., 320 U.S. 467 (1943) | 10 |
| Higgins v. Commissioner, 312 U.S. 212 (1941) | 12, 20, 21 |
| Howell v. Commissioner, 69 F. 2d 447 (C.C.A. 8th, 1934) | 46 |
| Janeway v. Commissioner, 147 F. 2d 602 (C.C.A. 2d, 1945) | 41, 43 |
| Janeway, Edward G., 2 T.C. 197 (1943) | 41 |
| Jarvis, William D. P., 43 B.T.A. 439 (1941) | 44 |
| Jephson, George S., 37 B.T.A. 1117 (1938) | 23 |
| Kales v. Commissioner, 101 F. 2d 35 (C.C.A. 6th, 1939) | 11, 14 |
| Katzinger Co., Edward, 44 B.T.A. 533 (1941) | 38, 39, 40, 47 |
| Kittredge v. Commissioner, 88 F. 2d 632 (C.C.A. 2d, 1937) | 22 |
| Lincoln Nat. Life Ins. Co. v. Mathisen, 150 F. 2d 292 (C.C.A. 9th, 1945) | 8 |

LIST OF CITATIONS (Cont.)

| | Page |
|---|----------------|
| Matson Navigation Co. v. Hansen, 132 F. 2d 487 (C.C.A. 9th, 1942) | 8 |
| Miller v. Commissioner, 102 F. 2d 476 (C.C.A. 9th, 1939) | 14, 21 |
| Nicolai, Harry T., 42 B.T.A. 899 (1940) | 38 |
| Pyne, United States v., 313 U.S. 127 (1941) | 12 |
| Quinn, John J., P-H T.C. Memo. Dec. Par. 46,254 (1946) | 40 |
| Richards v. Commissioner, 81 F. 2d 369 (C.C.A. 9th, 1936) | 11, 18 |
| Stephenson v. Commissioner, 101 F. 2d 33 (C.C.A. 6th, 1939) | 21 |
| Stimson v. Tarrant, 132 F. 2d 363 (C.C.A. 9th, 1943) | 8 |
| Tatt v. Commissioner, 166 F. 2d 697 (C.C.A. 5th, 1948) | 17 |
| Tricou v. Helvering, 68 F. 2d 280 (C.C.A. 9th, 1933) | 11 |
| Universal Pictures Co. v. Cummings, 150 F. 2d 986 (C.C.A. 9th, 1945) | 8 |
| Van Clief v. Helvering, 135 F. 2d 254 (App. D.C., 1943) | 37, 39, 40, 44 |
| Van Dyke, Ida A., 23 B.T.A. 946 (1931) | 21 |
| Wallace's Estate v. Commissioner, 101 F. 2d 604 (C.C.A. 4th, 1939) | 17 |
| Watson v. Commissioner, 124 F. 2d 437 (C.C.A. 2d, 1942) | 21 |
| White, Ethel S., P-H T.C. Memo. Dec. Par. 47,262 (1947) | 40 |
| Whitney v. Commissioner, 73 F. 2d 589 (C.C.A. 3d, 1934) | 18 |

LIST OF CITATIONS (Cont.)

| | Page |
|---|------|
| Winnett v. Helvering, 68 F. 2d 614 (C.C.A. 9th, 1934) | 11 |
| Wittmayer v. United States, 118 F. 2d 808 (C.C.A. 9th, 1941) | 8 |

Law Review Articles

| | |
|---|----|
| Note in 41 Col. L. Rev. 757 (1941)..... | 13 |
|---|----|

Statutes and Regulations

Internal Revenue Code:

| | |
|---|----------------------------------|
| Section 23 (k)..... | 2, 5, 30, 31, 32, 33, 34, 35, 49 |
| Section 23 (s)..... | 49 |
| Section 122 | 2, 5, 12, 30, 31, 50 |
| Section 322 | 2 |
| Section 3772 | 2 |
| 28 U.S.C.A. Section 41 (5)..... | 2 |
| 28 U.S.C.A. Section 225 (a)..... | 3 |
| Treasury Regulation 111, Section 29.23 (k)-6..... | 32, 34 |

Rules of Court

| | |
|---|------|
| Federal Rule of Civil Procedure 52 (a)..... | 6, 8 |
|---|------|

In the United States
CIRCUIT COURT OF APPEALS
for the Ninth Circuit

J. W. MALONEY, United States Collector of
Internal Revenue for the District of Oregon,
Appellant,

v.

GRACE NEFF SPENCER, Executrix,
Appellee,
UNITED STATES OF AMERICA,
Interpleader-Appellant.

On Appeal from the District Court of the United States
for the District of Oregon.

BRIEF OF APPELLEE

OPINION BELOW

The District Court wrote no opinion. Its finding of fact and conclusions of law (Tr. 67-82) are reported in 73 F. Supp. 657.

JURISDICTION

The taxpayer, C. B. Spencer, plaintiff below, paid the appellant, J. W. Maloney, the sum of \$152,619.84 on account of his combined income and victory tax lia-

bility for the tax period beginning March 1, 1942, and ending February 29, 1944 (Tr. 78, par. XVIII).

On or about April 21, 1945, the taxpayer filed with said appellant a claim for refund within the time allowed by Section 322 of the Internal Revenue Code, as amended (28 U.S.C.A. Sec. 322), and in accordance with the provisions of said section and Section 3772 of the Internal Revenue Code, as amended (28 U.S.C.A. Sec. 3772), (Tr. 4, 6-42). This claim is in the sum of \$93,-565.04, and is based on the ground that the taxpayer was entitled to a net operating loss carry-back due to certain losses sustained during the tax year ended February 28, 1945, under the provisions of Sections 23 (k) and 122 of the Internal Revenue Code, as amended.

After the filing of this claim for refund more than six months passed without the receipt of notice of allowance or disallowance by the Commissioner of Internal Revenue, whereupon the taxpayer within the time provided in Section 3772 of the Internal Revenue Code (28 U.S.C.A. Sec. 3772) and on October 27, 1945, filed his complaint in this cause in the District Court of the United States for the District of Oregon (Tr. 2 et seq.; 78, par. XIV) for the recovery of the amount of said claim.

Jurisdiction of this cause was conferred upon the District Court by Section 24 of the Judicial Code of the United States, as amended (28 U.S.C.A. Sec. 41 (5)), which section was in effect at the time the complaint was filed and judgment entered below.

The case was tried without a jury, and on June 24, 1947, the District Court made and entered judgment against said appellant (Tr. 83-84).

Notice of appeal was filed by appellants on September 19, 1947 (Tr. 85). Jurisdiction to review judgments of the District Court, in cases such as this, was conferred on this Court by Section 128 (a) of the Judicial Code of the United States, as amended (28 U.S.C.A. Sec. 225 (a)), which section was in effect at that time.

C. B. Spencer, plaintiff below, was dead when the notice of appeal was filed. A motion of the appellants to substitute the executrix of the Estate of C. B. Spencer, Deceased, as appellee herein was granted by this Court October 8, 1948.

QUESTION PRESENTED

At page 3 of their brief the appellants state the following as one of the questions determinative of the issue in this case:

" . . . whether the taxpayer was engaged in a statutory trade or business regularly carried on by him by financing only his three wholly-owned and controlled cannery corporations during the taxable year, . . ."

Appellee makes no contention that the taxpayer's business was limited to financing, and the court did not find that it was.

STATUTES INVOLVED

These are set forth in the Appendix, *infra*.

STATEMENT

In restating the substance of finding No. VIII appellants at page 7 of their brief say:

“The sums owed the taxpayer by those corporations were unpaid balances on open accounts receivable of the taxpayer [plaintiff below] and *not* open accounts payable of the corporations, . . .” (Italics inserted)

The italicized word “not” is obviously a misprint. The printed transcript gives the word as “no” (Tr. 72) and that is obviously a transposition of letters, although correctly copied from the findings signed by the trial judge. That the word “on” was intended rather than the word “no” is made abundantly clear from the findings taken as a whole, from the entire record and from the following quotation from page 18 of the appellants’ brief:

“The taxpayer made advancements to them [the two corporations] which were carried on their books as accounts payable to the taxpayer.”

SUMMARY OF ARGUMENT

The taxpayer is entitled to carry back and deduct the net operating loss suffered in 1945.

It is the position of the taxpayer that he is entitled to carry back and deduct from gross income for the tax-

able period beginning March 1, 1942 and ending February 29, 1944 the net operating loss sustained in the taxable year ended February 28, 1945 under the provisions of Section 122 of the Internal Revenue Code. In order to come within the provisions of that section it is necessary for the taxpayer to sustain an excess of losses as measured by deductions allowable under Chapter One of the Internal Revenue Code. One such deduction is allowable in the case of a business bad debt (Sec. 23 (k) (1)).

The application of Section 23 (k) (1) is such that debts are allowable without limitation as deductions if they become worthless as an incident to the business of the taxpayer. The lower court in effect found that the business of the taxpayer was owning, developing and leasing packing plants and [and as an incident thereto] providing, through guarantee and otherwise, adequate financing of the leased plants. This providing of financing was *only incidental to the taxpayer's business of owning, developing and leasing of food processing plants*, as indicated by the provisions in the leases and the form of the findings themselves. The debts due the taxpayer with which we are concerned arose in his business of owning, developing and leasing plants, and when they became worthless he was still engaged in the same business. The obligations then, under any viewpoint, were obligations, the worthlessness of which was incurred in trade or business.

On the question of the character of the obligations themselves, the law is clear that the intent of the party

in making the advances governs. Where the taxpayer advances such funds with the thought of repayment and does not contemplate their investment as a permanent part of the business, his intent controls; and the advances are treated as loans. This should be particularly true in this case where the obligations of the debtors to the taxpayer arose only incidentally and as the result of a condition in the agreement whereby the taxpayer leased the plants he had acquired and equipped. Had the operations of the debtors been successful, their notes would have been paid; and it would be clear that the taxpayer had put no sums into the business.

This court has consistently applied Federal Rule of Civil Procedure 52 (a) to the effect that findings of a District Court in a non-jury case will not be set aside unless clearly erroneous. The findings of the lower court were to the effect that the taxpayer was in the business of "acquiring, owning, expanding, equipping, and leasing food processing plants. . ." As an incident of such business the taxpayer provided for the adequate financing of the operations of the leased plants. The burden of showing the findings to be erroneous is upon the appellants. While the appellants purport to object to those findings (Br. 5, fn. 3), they never once in their brief point out wherein the finding is erroneous as being unsupported by evidence. Instead, they have a mistaken conception of the incidental findings of fact, namely, that the taxpayer as a part of his business provided financing of the operations of the plants which he owned, developed and leased, and have assumed that financing was the only business in which the Court found that the taxpayer

was engaged. Obviously the owning, developing and leasing of the packing plants was the principal part of his business. As the appellants have not met the burden which the law imposes upon them, nor even contested the findings below, they must necessarily fail in their appeal.

ARGUMENT

A. Taxpayer was engaged in a business regularly carried on by him. The findings of the District Court shall not be set aside unless clearly erroneous.

The District Court in the trial of this case found as a fact that the taxpayer during the taxable years ended February 29, 1944 and February 28, 1945 "was engaged in the business of acquiring, owning, expanding, equipping, and leasing food processing plants and providing, through guarantee and otherwise, adequate financing of the operations of such plants; and the said business during said time was regularly carried on by the plaintiff for profit." (Tr. 68). In effect this is that the principal business of the taxpayer consisted of owning, developing and leasing packing plants, and that the adequate financing of plant operations was an incident of his business.

To avoid any question as to the extent to which providing financing was incidental, the pertinent provision contained in each cannery lease is set out below.

"Financing: It is recognized that large sums of money will be required to finance the operations of LESSEE, and LESSORS hereby agree that when

required they will provide (through personal guarantee and through the pledge of such of their property covered by this Lease as may be necessary) adequate financing for the needs of LESSEE, as a part of the services to be performed in consideration of the rental to be paid hereunder."

The Federal Rules of Civil Procedure, Section 52 (a), provide that in non-jury cases "Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses." Findings of fact will not be disturbed by an appellate court when supported by substantial evidence, *Brodie Co. v. Hydraulic Press Mfg. Co.*, 151 F. 2d 91 (C.C.A. 9th, 1945); or by competent evidence of probative character, *Lincoln Nat. Life Ins. Co. v. Mathisen*, 150 F. 2d 292 (C.C.A. 9th, 1945); and such findings are presumptively correct unless "some obvious error of law, or mistake of fact has intervened", *Wittmayer v. United States*, 118 F. 2d 808 (C.C.A. 9th, 1941). Of similar import are *Universal Pictures Co. v. Cummings*, 150 F. 2d 986 (C.C.A. 9th, 1945); *Stimson v. Tarrant*, 132 F. 2d 363 (C.C.A. 9th, 1943); *Matson Navigation Co. v. Hansen*, 132 F. 2d 487 (C.C.A. 9th, 1942); *Gates v. General Casualty Co.*, 120 F. 2d 925 (C.C.A. 9th, 1941).

At page 16 of their brief, appellants say:

" . . . in order to prevail, it is incumbent upon the taxpayer to establish (a) that his activities in financing and guaranteeing the obligations of only his three wholly-owned and controlled cannery corporations during the taxable year constituted 'the operation of a trade or business regularly carried on' by him, . . . "

This is inaccurate in two respects. First, it is not incumbent upon the appellee to establish that taxpayer was in the business described in quotation, as we shall herein-after show. Second, on this appeal, the burden of establishing that the findings of the lower court are clearly erroneous, not supported by substantial evidence, and the result of mistake of law or fact is upon the appellants. *Augustine v. Bowles*, 149 F. 2d 93 (C.C.A. 9th, 1945).

APPELLANTS FAIL TO SUSTAIN BURDEN

It is submitted at the outset of this argument that the appellants have not sustained the burden which the law casts on them. Instead they have chosen to side-step the main issue of the case and substitute another for it. The findings of the lower court are clear. They state what the business of the taxpayer was. Nevertheless, the appellants in their brief have disregarded the findings of fact of the lower court and have argued the case on the theory that the court found the taxpayer was engaged only in the "business of financing canneries" (Br. 18; Also 5, fn. 3; 11; 16; 19; 22). The court did not make such a finding. The language of the lower court makes it clear that providing financing was merely a necessary consequence of the main business of the taxpayer, which consisted of owning, developing and leasing canneries. In any event, it cannot be argued that the court found that the taxpayer's business consisted *only* of financing canneries or, in the language of the court, of providing "adequate financing".

The court found, and there is no argument to the contrary, that the leasing of canneries was embraced in the operation of the taxpayer's business. Had the court restricted its findings to this single point of leasing, such findings would have qualified the taxpayer for the deduction and carry-back.

The gist of the appellants' contention is that the taxpayer was engaged in no trade or business, yet he does not contest the finding of the court that the taxpayer was engaged in the business of "acquiring, owning, expanding, equipping and leasing food processing plants. . . ." In fact, this was the principal business of the taxpayer.

Whether the taxpayer was engaged in the business of financing canneries (or of providing financing) is of little importance. As is shown *infra*, pp. 29-35, it is necessary only that the financing resulted in a loss which bears a visible *relation* to the business of the taxpayer. They need not themselves be *the* business. Determination of this *relation* is primarily a factual matter. In *Commissioner v. Heininger*, 320 U.S. 467 (1943), the Court said:

"Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances."

The appellants have set up a straw man as a finding and have proceeded to challenge it, but have not attempted to question the actual findings. The findings of the lower court must stand since they are supported by an ample amount of competent evidence. It is submitted

that, since appellants place their main reliance for reversal upon the fact that the taxpayer was engaged in no business, the appellants' case fails *a priori*, and the judgment of the lower court should be upheld.

TRADE OR BUSINESS: A QUESTION OF FACT

Although the burden on this appeal lies with the appellants, it may prove useful to examine several of the cases dealing with the meaning of trade or business. The appellants urge that what constitutes a trade or business necessarily involves a conclusion (Br. 22-23), but it appears that this involves a conclusion of fact. In *Richards v. Commissioner*, 81 F. 2d 369 (C.C.A. 9th, 1936), this court said:

"The Commissioner contends that the real property in question was not a capital asset, and the issue presented to the Board was whether or not the real property was 'held by the taxpayer primarily for sale in the course of his trade or business'. The determination of this issue is the ultimate fact."

See also *Winnett v. Helvering*, 68 F. 2d 614 (C.C.A. 9th, 1934); *Tricou v. Helvering*, 68 F. 2d 280 (C.C.A. 9th, 1933). In *Cecil v. Commissioner*, 100 F. 2d 896 (C.C.A. 4th, 1939), the court stated:

"The term 'business' as here used was evidently not intended to have a technical meaning but to be understood in its ordinary acceptation."

And in *Kales v. Commissioner*, 101 F. 2d 35 (C.C.A. 6th, 1939), in deciding whether certain expenses arose from carrying on a business the court remarked:

"Where statutory standards are lacking, it may, we think be here said . . . that 'language is to be read in its natural and common meaning'."

In the light of these decisions the appellants' statement at page 22 of their brief that the District Court used the language of the statute in finding that the business in which the taxpayer was engaged was "regularly carried on by him" and their accompanying criticism of that is without substance. As a matter of fact the court's finding was "and that said business was regularly carried on by the plaintiff for profit" (Tr. 68). That is merely the statement of an ultimate fact. The statute does not use the words "for profit" (28 U.S.C.A. Sec. 122 (d) (5)). Appellee submits it is proper to use the words of the statute in stating a conclusion of law as was done in Conclusion No. II (Tr. 27).¹

The conclusion of law to be drawn is whether the business as found to exist is one of which the tax statutes take cognizance. As was stated in the leading case of *Higgins v. Commissioner*, 312 U.S. 212 (1941):

"To determine whether the activities of a taxpayer are 'carrying on a business' requires an examination of the facts in each case."

The Court stressed this point again in *United States v. Pyne*, 313 U.S. 127 (1941), and reversed the Court of Claims because that court had found only that the activities in question had been substantially the same as those

¹It should be noted that at page 22 of their brief, as at other places therein, appellants disregard what the court found to be the business of the taxpayer and assert that the finding was "that the taxpayer was engaged in the business of cannery financing."

of a predecessor who had been a "financier and investor". The decision, then, was principally the result of the "Failure of the Court of Claims to make a specific finding on this ultimate and determinative issue", i.e., that the taxpayer himself was carrying on a trade or business. Thus, it becomes apparent that the trier of fact, after viewing all the evidence presented, must determine whether or not a business has been conducted, and his determination is primarily one of fact. The standard is a broad one that varies with each case and circumstance. See note 41 Col. L. Rev. 757 (1941).

THE TEST OF FREQUENCY AND CONTINUITY

An important guide used by courts in ascertaining whether operations constitute a business within the contemplation of the Internal Revenue Code is whether or not there was visible activity as opposed to mere passivity. Where entrepreneurial activity is found the courts have uniformly held that such business exists.

In *Commissioner v. Boeing*, 106 F. 2d 305 (C.C.A. 9th, 1939), this court said:

"From the cases it would appear that the facts necessary to create the status of one engaged in a 'trade or business' revolve largely around the *frequency* or *continuity* of the transactions claimed to result in a 'business' status." (Italics inserted)

The court there held that the taxpayer who had contracted with certain parties to log off and sell the timber on lands owned by him was engaged in business for the

purpose of the tax statutes. This same rule was followed in *Ehrman v. Commissioner*, 120 F. 2d 607 (C.C.A. 9th, 1941), where the court sustained the finding of the Board of Tax Appeals that the taxpayers were engaged in the business of subdividing and selling real estate. In *Daily Journal Co. v. Commissioner*, 135 F. 2d 687 (C.C.A. 9th, 1943), the court in sustaining the deductions taken by the taxpayer stated that:

“Petitioner’s managerial activities in Consolidated were ‘Extensive, varied, continuous, and regular.’”

This same language as a basis of decision is found in *Miller v. Commissioner*, 102 F. 2d 476 (C.C.A. 9th, 1939), and *Kales v. Commissioner*, 101 F. 2d 35 (C.C.A. 6th, 1939). In *Foss v. Commissioner*, 75 F. 2d 326 (C.C.A. 1st, 1935), the court in sustaining a deduction for lawyer’s fees remarked:

“The line comes between those who take the position of passive investors, doing only what is necessary from an investment point of view, and those who associate themselves actively in the enterprises in which they are financially interested and devote a substantial part of their time to that work as a matter of business.”

In *Dalton v. Bowers*, 287 U.S. 404 (1932), the Court disallowed a claimed loss due to the worthlessness of stock of a corporation held by the taxpayer. As appellants have pointed out in their brief (Br. 27), this was because the taxpayer “was not *regularly* engaged in the business of buying and selling corporate stocks”. (Italics inserted). The situation represented an isolated transaction. It should be noted also that the taxpayer in the

case at bar is claiming no deduction for the worthlessness of stock. His business did not involve stock or bond transactions. As is frequent in stock loss cases, the *Dalton* case involves problems difficult to determine and not present in the instant case, consequently the *Dalton* case is of no practical value in deciding the present case other than focusing attention on the fact that in the *Dalton* case the court was dealing with an isolated transaction.

Likewise, in *Burnet v. Clark*, 287 U.S. 410 (1932), the Court refused a claim for losses resulting from the indorsement of a corporation's notes because as the Court stated (quoted in appellants' brief p. 24-25):

"Aside from endorsing an undisclosed number of notes of this company there is nothing in the record to indicate that acting as endorser or guarantor constituted a business or trade with the petitioner. So far as the record shows these were the only notes ever endorsed by the petitioner for the Bowers Company or for any other company or person. From the facts in the case we are of the opinion that the loss did not result from the operation of a trade or business *regularly* carried on by the petitioner but resulted from *isolated* or *occasional* transactions." (Italics inserted)

The Court also remarked:

"He was not *regularly* engaged in endorsing notes, or buying and selling corporate securities. The unfortunate indorsements were no part of his ordinary business, but *occasional* transactions intended to preserve the value of his investment in capital shares." (Italics inserted)

It is only necessary to point out that it was not the in-

dorsing of the notes by the taxpayer in the case at bar which constituted his business. Rather it was the owning, acquiring, expanding, equipping and leasing which constituted the clearly defined planes of his business. His indorsements or guarantees were merely incidental to that business.

The findings of fact and the record speak for themselves in saying that the business of the taxpayer was extensive, regular and continuous. He owned, acquired, expanded, equipped and leased canneries, not to mention the providing of financing which he undertook as an incident thereto. The taxpayer testified that he acquired and leased canneries; that after acquiring them he had to enlarge them and build additional buildings, buy new equipment and see that the plants were kept in operating condition, and that in pursuit of these duties he had to travel from Portland to Albany, from Lebanon to Portland, from Yakima to Seattle, to Washington, D. C.; that the value of the additions he made to the plants was over a \$100,000.00; that the additions were made during the time he was renting the plants to the corporations; that his business activities required about one-third of his time and required weekly attention (Tr. 120-124). There would, of course, be costs in acquiring the plants before he undertook to lease them, the amounts of which are not mentioned in the testimony. Mr. Bingham Powell, taxpayer's son-in-law and secretary-treasurer of each of the three leased food processing plants, testified that the taxpayer engaged in all the activities which were necessitated in enlarging, expand-

ing and improving the various plants which he was leasing to the corporations, which meant construction of buildings, the purchasing of materials and machinery, the arrangement and redesigning of existing plants and that the machines and plants were owned by the taxpayer and were on the leases with the canneries, that the taxpayer spent from 30 to 40 per cent of his time in doing these things and that the value of the additions he made to the plants was better than \$100,000.00 (Tr. 178, 192, 193).

THE PROFIT TEST

In determining what constitutes carrying on a business a frequently used criterion is whether or not the taxpayer was engaged in the particular activity for profit, rather than as a hobby, or for pleasure. In *Tatt v. Commissioner*, 166 F. 2d 697 (C.C.A. 5th, 1948), the taxpayer had operated a farm with the idea of raising a part of the commodities sold in his main business of selling produce. His operations were unsuccessful, and losses resulted. The court allowed the deductions claimed because the farm had been operated for profit rather than for pleasure and was therefore a business. This same principal has been followed in numerous cases: *Wallace's Estate v. Commissioner*, 101 F. 2d 604 (C.C.A. 4th, 1939), in which the executrix of her husband's estate was held to be engaged in business for purposes of taking a deduction from taxes; in *Cecil v. Commissioner*, 100 F. 2d 896 (C.C.A. 4th, 1939), the operation of the famed Biltmore Estate in North Carolina as a museum

and park was held to be business within the meaning of the statute; *Richards v. Commissioner*, 81 F. 2d 369 (C.C.A. 9th, 1936), was a case in which lots of the taxpayer were held primarily for sale in the course of his business; *Whitney v. Commissioner*, 73 F. 2d 589 (C.C.A. 3d, 1934), where it was held that a racing stable was operated as a business for profit rather than for pleasure; *Commissioner v. Field*, 67 F. 2d 876 (C.C.A. 2d, 1933), held that in operating a farm and racing stable, the taxpayer, whose principal occupation was banking, was engaged in a business within the purview of the statute; *Doggett v. Burnet*, 65 F. 2d 191 (App. D.C., 1933), held that the publication and marketing of the works of an English religious teacher constituted a business, the court saying:

“The proper test is . . . whether it is entered into and carried on in good faith and for the purpose of making a profit, or in the belief that a profit can be realized thereon, and that it is not conducted merely for pleasure, exhibition, or social diversion.”

These cases also state that whether the activity is entered into for profit is primarily a matter of intent.

That the activities of the taxpayer conform to this test is readily apparent. They were clearly undertaken for compensation, namely rent from the leasing of the plants (Tr. 124). The court found he was engaged in business “for profit” (Tr. 68).

Finally, it must be observed that the notion of profit upon which the courts rely is to be distinguished from the mere opportunity for gain, and that it includes de-

cision making (or risk taking) functions *other* than those which inhere in the mere investment of capital through stock purchases. Thus in *Deputy v. duPont*, 308 U.S. 488 (1940), the Court refused to sanction certain deductions as ordinary and necessary expenses incurred in carrying on a business because the original business decision that had given rise to the expenses claimed had been the decision of the *corporation* in which the taxpayer had been a stockholder and had not been *his own*. The taxpayer had undertaken the particular transactions only after the corporation had found certain difficulties of both a legal (*ultra vires*) and financial nature in the way of its carrying out the transactions. In the case now before the court for decision the obligations which the taxpayer undertook to guarantee were a deliberate and articulate part of the transactions first entered into by the *taxpayer* whereby *he* leased the plants as part of *his* business as found by the District Court.

It is also incumbent upon the appellee to correct what appears to be a discrepancy in the reporting of the above case by the appellants in their brief (p. 28). The appellants state that the deduction was disallowed "on the ground that the taxpayer was not engaged in the business of trading in securities". It is submitted that the court made no such decision. It even granted *arguendo* that the taxpayer was engaged in a trade or business, saying:

"But as we view the case it is unnecessary for us to pass on that contention and to make the delicate

dissection of administrative practice which that would entail. For we are of the opinion that the deductions are not permitted . . . even though we were to assume that the activities of respondent constituted a business, as found by the District Court."

In *Deputy v. duPont* Justice Frankfurter wrote a concurring opinion from which the appellants on page 29 of their brief made the following quotation:

"‘carrying on any trade or business,’ within the contemplation of Section 23 (a), involves holding one’s self out to others as engaged in the selling of goods or services. . . ."

It would appear from a reading of the appellants’ brief that the essence of their argument is based on the idea embraced in the quotation, for they repeat, in one way or another, the observation that the taxpayer financed and guaranteed only the operations and obligations of his three canneries, not those of other canneries or corporations generally (Br. 14, 18, 19, 33). Justice Frankfurter’s opinion obviously does not amount to an expression of the Supreme Court and no notice of it was taken in the subsequently decided *Higgins* case, *supra*, and so far as appellee has been able to discover, no notice has been taken of that statement in any other Supreme Court case. In *Daily Journal Co. v. Commissioner*, *supra*, this Court cited the *duPont* case and quoted a portion of the foregoing statement of Justice Frankfurter. The *Daily Journal Co.* case shows that Justice Frankfurter’s definition is to be applied in a broad and reasonable manner, as this court in that case gave

weight to its former opinion in the case of *Miller v. Commissioner*, *supra*. It is also worthy of note at this point that this court distinguished the investment activities of the taxpayer in *Higgins v. Commissioner*, *supra*, from the situation confronting the court in *Daily Journal Co.*, *supra*.

Immediately following their quotation from Justice Frankfurter, appellants say:

"To the same effect, see *Van Dyke v. Commissioner*, 23 B.T.A. 946, . . . also *Watson v. Commissioner*, 124 F. 2d 437, 439 (C.C.A. 2d) . . . *Stephenson v. Commissioner*, 101 F. 2d 33 (C.C.A. 6th), . . . and *Gruver v. Helvering*, 70 F. 2d 292 (App. D.C.)."

None of those cases contain language in any way similar to that of Justice Frankfurter. The language "To the same effect" undoubtedly refers to the *Dalton* and *Burnet* cases, *supra*. A reading of the four cases mentioned in the quotation clearly shows that their facts are not like those of the case at bar. The appellee does not contend that the business of the taxpayer and the three corporations was the same. She does not seek to disregard the corporate entities. She does not claim the taxpayer was solely in the financing business. Her contention is that such financing as was provided by the taxpayer was incidental to his primary business of acquiring, owning, expanding, equipping and leasing of food processing plants.

SIMILAR CASES

Finally, there should be noted the similarity between the instant case and the other decisions. In *Kittredge v. Commissioner*, 88 F. 2d 632 (C.C.A. 2d, 1937), the question of an allowance of depreciation on property used in trade or business was before the court. The taxpayer in that case was the owner of only two wineries which he leased. The court upheld the contention that these were properties used in trade or business, saying:

"Obviously, the petitioner was engaged in the winery business during the years in question, for he was operating through lessees other winery properties in California. Equally obvious is it that the Weston Winery was used in his business while a tenant was operating it on shares as a grape juice plant until early in 1922."

On pages 30 and 31 of their brief appellants have attempted to criticize or distinguish the cases of *Kittredge v. Commissioner*, *supra*; *Glenn M. Averill*, 20 B.T.A. 1196 (1930), and *Edwin H. Conrades*, 21 B.T.A. 213 (1930), which were cited and relied upon by the taxpayer in the lower court. We submit that the *Kittredge* case, *supra*, is in point because it shows that the leasing of property constitutes doing business within the meaning of Section 23 (k) of the Revenue Act of 1928, which permitted as a deduction:

"A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. . ."

The *Averill* case, *supra*, teaches that it is not necessary that the taxpayer should sustain the loss in his prin-

cipal business or vocation, and that he is entitled to business loss deductions if the loss is incurred in any trade or business regularly carried on by him. The *Conrades* case, *supra*, was cited by the taxpayer primarily for the purpose of showing that it is permissible under the Revenue Acts for a person engaged in business to limit the field of his activities if he chooses to do so. In this case the court said:

“The fact that petitioner limited the field of his loans to corporations directed by him and individual associates with whose affairs and financial standing he was familiar, does not alter the fact that in making these loans he was carrying on a personal business distinct from the business carried on by the corporations in question. There is nothing in our opinion peculiar or significant in such limitation. . .”

In *George S. Jephson*, 37 B.T.A. 1117 (1938), the taxpayer, a manufacturer of food products, bought a house for the purpose of renting it. Although he listed it with a broker and took other steps, he was unable to rent it. The Board held that he was in business for the purpose of taking a depreciation deduction, saying at page 1119:

“He had no purpose to occupy the property as his own residence and never in fact did occupy it. Thus it can fairly be said that he was carrying on a business, albeit without actual profit during the years in question. Obviously the inability to rent or sell the property at a profit during the taxable years does not take from the venture its business character, nor does the fact that the petitioner was not devoting his full time to a real estate business.”

Cases quite close to the *Jephson* decision are too numerous to cite. Typical is *Leland Hazard*, 7 T.C. 372 (1945).

COMMENTS ON STATEMENTS AND ARGUMENTS OF APPELLANTS

At several places in their brief appellants have restated findings of the court in which the terms "such business" and "such business regularly carried on by the taxpayer" were used, and then objected to them on the theory that the terms referred to a finding by the court that the taxpayer's only business was "financing canneries". As we have pointed out the court made no such finding, and the terms "such business" and "such business regularly carried on by the taxpayer" as used in the findings means the taxpayer's business of owning, developing and leasing canneries and as an incident thereto providing financing for the operation of leased plants.

On page 19 of their brief, appellants say:

" . . . the District Court's ultimate finding and conclusion that the taxpayer was engaged in the business of financing and guaranteeing the obligations of cannery corporations, generally, . . . find no support in the undisputed facts and the evidence of record, or in the statute and controlling decisions."

The court made no such finding. At the bottom of page 11 of their brief, appellants say:

"Upon the basis of the foregoing facts the District Court held that the taxpayer was engaged in the business regularly carried on by him of guaranteeing the operations of his three wholly-owned corporations during the taxable years 1944 and 1945, . . ."

The court made no such holding, as is obvious from an examination of its Conclusions I through X (Tr. 79-82).

At the bottom on page 13 of appellants' brief they say that the District Court's findings and conclusions to the effect that the taxpayer's losses were "attributable to the operation of a trade or business regularly carried on by taxpayer" are directly opposed to the undisputed facts which show that the taxpayer was not engaged in such business, generally. Appellee has already pointed out that the court's findings are amply supported by the facts. Disregarding the taxpayer's business as actually found by the court, appellants near the top of page 14 of their brief advance the following argument:

"The taxpayer, the sole stockholder of his three cannery corporations, financed and guaranteed only their operations and obligations, respectively, not those of other canneries or corporations generally. Therefore, he was not engaged in carrying on such business regularly."

It is not clear to what the term "such business" in the last sentence of the quotation refers. If it refers only to the first sentence of the quotation, the second sentence is unsound because it disregards most of the facts in the case. If, however, it refers to the type of business mentioned in the first sentence of the paragraph, which is at the bottom of page 13 of appellants' brief, it is completely illogical for the same reason. The conclusion of the argument constitutes a *non sequitur*. Appellee makes no contention that the taxpayer's business was that of financing and guaranteeing the operations and obligations of other canneries or corporations generally, and as we show it is not necessary that he should have done so in order to recover in this case.

At page 19 of their brief, appellants say that taxpayer financed "his own three cannery corporations, . . . in order 'to protect' his stock in those corporations (R. 157-158)". An examination of the cited pages of the record shows that on cross examination counsel used the term "to protect" in questioning the taxpayer. But he did not testify as the appellants' brief indicates.

Appellants' reluctance to meet the real issue in this case is well illustrated by the opening sentence of their argument beginning on page 17 of their brief. What has already been said amply shows what the taxpayer's business was.

Appellee dislikes taking issue with every little inaccuracy in the appellants' brief. Many have been passed by without comment. There are, however, three or four more that we feel should be mentioned.

On page 20 of appellants' brief, it is stated:

" . . . the taxpayer, as sole stockholder, expanded his credit and invested the money by financing the three cannery enterprises (R. 123), which were wholly without assets or capital otherwise (R. 105, 161), . . . and that when they turned out to be unprofitable enterprises . . . he 'sold out' the canneries and took the losses (R. 104, 158-159, 160-161)."

Page 123 of the transcript does not show that taxpayer engaged in financing "as sole stockholder". On the contrary that page virtually shows he did it as owner or lessor, and the leases, which are the best evidence, show that taxpayer provided the financing as lessor. The corporations were not wholly without assets until after they

were liquidated. On page 105 taxpayer's counsel said that after February 15, 1945, "that corporation was wholly without assets". That was the date the corporation was liquidated. Before that they had the leases and the growers' contracts. These were valuable assets. Plants and machinery were extremely difficult to acquire during the war. The taxpayer testified that a new corporation or cannery could not go into business without growers' contracts, as a cannery must have raw products on which to work, and that contracts furnished them with a supply (Tr. 146), that the growers' contracts turned over to the Yakima corporation were of a value considerably in excess of \$10,000.00, and that those turned over to the Dehydrator corporation in exchange for its capital stock were in excess of \$5,000.00 (Tr. 147). After the corporations were in operation they also acquired other assets (Tr. 104, 106, 107). It is true that on page 161 the taxpayer testified as follows:

"Q. They did not have assets for that purpose [money to start operating (Tr. 160)] when they were incorporated?

A. That is right."

This question and answer, however, in the light of all the other testimony and evidence in the case does not justify the statement that the corporations "were wholly without assets or capital". On pages 161 and 162 of the transcript the taxpayer testified that he started his original plant in Lebanon on the same basis. That was in 1935 (Tr. 116). It was financially successful as indicated by the tax return (Tr. 14). Furthermore, a separate enterprise, that of the Lebanon corporation, one

of the corporations involved in this case, was started in the same way (Tr. 160, 161), and it continued to operate after the other two of the three corporations were liquidated (Tr. 119). The history of American business is replete with successful enterprises that started with borrowed working capital. The reasons for the failure of the Yakima corporation and the Dehydrator corporation were not the lack of working capital, but inexperienced help, labor shortages, continued change in specification by the Government, inexperienced inspectors, high prices for raw materials, controlled prices for finished products, and loss of market for the product (Tr. 125, 141, 194, 195). The manner in which the appellants, in the last quotation, stated "sold out" the canneries and took the loss" would indicate that the taxpayer so testified, but an examination of the cited pages of the transcript shows that the appellants added the words "and took the losses" to the taxpayer's testimony.

Appellee is at a loss to understand what the appellants mean by the words "as requested" in the third line after the quotation on page 22 of their brief. As far as the record shows they requested no findings or conclusions.

At pages 9 and 10 of their brief, appellants say:

"The taxpayer's gross income from his business for the taxable year 1945 was \$33,562.28. He took business deductions for that year in the sum of \$17,-217.72, about which there is no dispute. This amount, together with the above two bad debts of \$95,081.48, taxes of \$223.21, and depreciation of \$31,617.89, gave the taxpayer business deductions

for that year in the aggregate sum of \$144,140.33. His net loss attributable to *the operations of his above business* for that taxable year was \$110,-578.05." (Italics inserted)

This is almost a literal quotation from the lower court's finding No. XIII (Tr. 75). Appellants do not object to any part of this finding except "in respect" of the italicized words (Br. 10, fn. 8). The part of finding XIII not objected to stands as a clear admission that the taxpayer was in some business, and as hereinbefore pointed out as long as he was in any business that qualified him for the full amount of a carry-back. Furthermore, the appellants do not object to the finding that the taxpayer took business deductions for the year 1945 "in the sum of \$17,217.72, about which there is no dispute". Consequently, this also stands as an admission that the taxpayer was in some business during that year, and as far as the record shows the only one he could have been engaged in was the one described in the findings (Tr. 68).

B. Where the taxpayer makes advances which are an incident to his main business of acquiring, owning, expanding, equipping, and leasing food processing plants, and such advances subsequently become worthless, they must be taken into account in computing the net operating loss deduction.

Appellants begin their argument concerning the bad debt phase of this case by asserting "that the taxpayer has the burden of establishing" that "the guaranteed

corporate obligations and accrued rentals represented bad debts and not contributions to capital" (Br. 32). The lower court found that the "sums owned to plaintiff by the corporations were unpaid balances on open accounts receivable of plaintiff, . . . and were and are debts which arose in the course of plaintiff's said business and were not contributions to the capital of said corporations or to the capital of either of them" (Tr. 72). Consequently the appellants are again inaccurate in their contentions. Under the doctrine of *Augustine v. Bowles, supra*, the burden of establishing that this finding is erroneous rests on the appellants.

In order to come within Section 122 of the Internal Revenue Code (28 U.S.C.A. Sec. 122) it is only necessary for the taxpayer to sustain an excess of losses allowable as deductions by Chapter 1 of the Internal Revenue Code over gross income, with the exceptions, etc. provided in sub-section (d). Section 23 (k) (1) provides for the allowance of such a deduction in the case of business bad debts incurred by an individual. The appellants in their brief have made much of the qualification set out in sub-section (d) (5) of Section 122, and have interpreted it as placing the burden upon the taxpayer of showing that the losses claimed were "attributable to the operation of a trade or business regularly carried on by the taxpayer". It is sufficient to point out that Section 122 (d) (5) is merely a qualification that applies in case the deductions involved are *not* attributable to business activities. Since by its terms Section 23 (k) (1) applies primarily to debts, the worthlessness of which is incurred in trade or business, it is necessary

to consider only the interpretation of the latter section. The qualification of Section 122 (d) (5) may be disregarded in so far as an interpretive standard is necessary to an understanding of bad debts.²

The application of Section 23 (k) (1) is such that the worthlessness of any debts claimed as deductions must have been incurred in a trade or business of the taxpayer. A showing that they became worthless as a circumstance in a trade or business of the taxpayer is sufficient to qualify the taxpayer for the deduction. The Senate Finance Committee Report on the 1942 Revenue Act (5 Mertens, Law of Federal Income Taxation, 1948 Supp. p. 259) in part says:

"The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which borrowed funds are put by the debtor, but is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is *not* a non-business debt for the purposes of this amendment." (Italics inserted)

This language has been incorporated verbatim into

²The record shows and the lower court found that the bad debts involved in this were "attributable to the operation of said business [of acquiring, owning, expanding, equipping and leasing of food processing plants . . . for profit (Tr. 68)] regularly carried on by the plaintiff" (Tr. 72); and the lower court concluded that the taxpayer incurred a loss in his said business from the worthlessness of said debts within the meaning of Sec. 23 (k) and was entitled to a net operating loss carry-back within the meaning of Sec. 122. In view of this appellee will not labor the point about which Section controls, as taxpayer's loss comes well within both of them. The distinction was mentioned only because appellee does not wish through silence to give the appearance of acquiescing in what she regards as an unwarranted interpretation of Sec. 122.

Treasury Regulation 111, Section 29.23 (k)-6. The examples which are included in the regulation make it clear that it is necessary only that at the time the debt becomes worthless it be a "proximate incident" of the trade or business in which the taxpayer is then engaged.

CASES INTERPRETING SECTION 23 (k)

An application of Section 23 (k) is found in *Robert Cluett, 3rd*, 8 T.C. 1178 (1947). The petitioner was a member of the New York Stock Exchange. In 1929 the membership was increased one quarter, and each member was given the right to transfer his proportionate part of an additional membership. The petitioner sold the one-fourth of a membership to which he was entitled but was never paid, and the debt resulting from the transaction became worthless in 1943. At that time the petitioner was still a member of the Exchange.

The contention of the Commissioner was that the petitioner was not regularly engaged in the business of buying and selling seats on the Exchange, and that the bad debt was a non-business bad debt. The court sustained the contention of the taxpayer that the loss resulted directly from the operation of a business in which the taxpayer was engaged both at the time the debt arose and at the time it became worthless. The court said:

"The debt . . . was closely related to the business of owning and using a stock exchange membership for the production of income, in which business the petitioner was engaged not only in 1929, when the debt was created, but also in 1943 when it became

worthless. . . . That debt arose in the course of the petitioner's business, which involved owning the Exchange membership, which, in turn, required a sale of the accretion in order to realize any benefit therefrom. He was still engaged in that same business in 1943 when the debt became worthless. Thus, the debt, at all times material hereto, bore a proximate relation to the business of the petitioner and the loss from its worthlessness also bore a proximate relationship to that business."

The only other case appellee has been able to find interpreting the business necessity aspect of Section 23 (k) added by the 1942 amendment is *Vincent C. Campbell*, P-H T.C. par. 11.61 (1948). In that case a bad debt deduction was claimed for losses resulting from advances on open account to a corporation. The debts became worthless in 1944. It was the practice of the petitioners to organize, own, and operate corporations engaged in the retail coal business. The advances which became worthless were incurred in this business of organizing and operating corporations engaged in the retail coal business. The court sustained the contention of petitioners and allowed the deduction on the ground that these debts "had a direct connection with the business carried on by these petitioners", and were the result of carrying on that business.

As determined by the court below, in the case at bar, the activities which constituted the business of the taxpayer were acquiring, owning, expanding, equipping, and leasing food processing plants, and (as an incident thereto) providing for the adequate financing of the operations of those plants. The court found that the taxpayer

was engaged in those activities during the taxable years ending February 29, 1944, and February 28, 1945 (Tr. 68), that is, when the obligations for which the bad debts are claimed arose, and when they subsequently became worthless. Whether the taxpayer was or was not engaged in the business of financing canneries is of no moment. It is significant only that the taxpayer was engaged in some business, and the court below so found. The debt arose in the course of that business, and they became worthless therein. They were a proximate incident of the business of the taxpayer.

No doubt influenced by *Dalton v. Bowers, supra*, and *Burnet v. Clark, supra*, the appellants have repeatedly pressed the argument that for appellee to succeed in this case she must show that the taxpayer was in the business of financing canneries generally. The attempt to portray the taxpayer as coming within the very narrow holdings of these two cases has resulted in appellants' insistence that the taxpayer must have been engaged in a business whose main element or characteristic was performance of acts *identical* to those which gave rise to the debts owing from the corporations to the taxpayer. The necessity for "worthlessness incurred in trade or business" was first made a part of the Internal Revenue Code in 1942. "Incurred in trade or business" does not call for *identity* of the debt-yielding acts of the taxpayer with the dominant acts of his trade or business. Regulation 111, Sec. 29.23 (k)-6 promulgated by the Commissioner as a guide to the interpretation of Sec. 23 (k), and the *Cluett* and *Campbell* cases,

supra, show that the acts which produce the debts may be dissimilar from the principal functions of the business as long as they are an "incident" of that business. The *Dalton* case and the *Burnet* case, decided in 1932, were not concerned with this problem. Their holdings are limited to whether or not the particular taxpayers there involved were carrying on a business and do not treat of bad debts as outlined in Sec. 23 (k).

C. Whether advances of the taxpayer represent obligations owed to him is primarily a matter of intent.

The court below found as a fact the Dehydrator corporation owed the plaintiff \$61,115.48 on account of accounts payable of said corporation which the taxpayer had previously guaranteed and did pay, and on account of notes payable to said corporation upon which the taxpayer was surety and which he did pay, and the Yakima corporation owed the taxpayer the sum of \$33,966.02 on account of unpaid rent, sums advanced by the taxpayer to said corporation to pay promissory notes of said corporation upon which he was surety and which sums were used by the corporation to pay said notes, lug boxes rented to said corporation by taxpayer and not returned by it to him because they had become broken, and money belonging to him and collected by said corporation, but not paid over to him by it. The court also found that *said sums owed to the plaintiff by the corporation were unpaid balances on open accounts receivable of the plaintiff* and were debts which arose

in the course of the plaintiff's said business and were not contributions to the capital of said corporation or to the capital of either of them (Tr. 71, 72).

During his opening statement counsel for the appellants said:

"There are no serious factual questions here involved. (Tr. 108).

"The facts here as to the amount of income and the amount of obligations paid are not in dispute at all, or, in any event, in a very minor way, . . ." (Tr. 109).

Apparently the portion of the above mentioned findings which we have italicized are the only part thereof questioned by the appellants (Br. 3, bottom of page; 5, fn. 3; 7, fn. 6; 12 and 13, points 2, 4). They do not question the fact that the sums mentioned were on open account balances as therein stated. In fact they virtually concede this by saying:

"It clearly is not important, we submit, that some of the items were carried on the corporations' books as debts due from them to the taxpayer (R. 104-105, 142-144), and that some of the obligations constituted unpaid and accrued rentals (R. 104, 124, 163), the entries of such transactions being merely evidential and not conclusive." (Br. 34).

The capital stock of the Lebanon corporation and the Yakima corporation was in the sum of \$10,000.00 each, and that of the Dehydrator corporation was \$5,000.00 (Tr. 145, 186, 200). This was paid for by turning over growers' contracts to the corporations (Tr. 185). Those

turned over to the Yakima corporation, as stated, were in a value in excess of \$10,000.00, and those turned over to Dehydrator corporation were of a value excess of \$5,000.00 (Tr. 147). The growers' contracts were carried on the corporation's books at amounts equal to the capital stock (Tr. 186, 200).

There is not the slightest evidence that taxpayer intended to contribute anything to the capital of the corporations beyond the growers' contracts, and he testified that he at no time contributed or intended to contribute any capital to any of the said corporations other than said contracts (Tr. 148).

There is no account in the books anywhere, either of the corporation or of the taxpayer, showing any contribution to capital other than the growers' contracts (Tr. 186), and there was no money or anything else that went into any capital account or any account like a capital account, other than the growers' contracts (Tr. 189). The growers' contracts were accepted by the directors of the corporation in full payment of the capital stock (Tr. 193). It is incumbent upon the appellants to point out wherein the evidence fails to support the above finding, and this we respectfully submit they have not done. Inasmuch as there is substantial evidence to support the findings they should not be set aside on appeal. See pages 8 and 9 hereof.

A loan or an advance in order to qualify for the bad debt deduction must actually create the relationship of debtor and creditor. Whether it does is primarily a matter of intent. *Van Cleef v. Helvering*, 135 F. 2d 254

(App. D.C., 1943); *Fairbanks, Morse & Co. v. Harrison*, 63 F. Supp. 495 (Ill., 1945); *Glenmore Distilleries Co., Inc.*, 47 B.T.A. 213 (1942); *Edward Katzinger Co.*, 44 B.T.A. 533 (1941); *Harry T. Nicolai*, 42 B.T.A. 899 (1940); *Daniel Gimbel*, 36 B.T.A. 539 (1937); *Lucia Chase Ewing*, P-H T.C. Memo. Dec. Par. 46,235 (1946).

In the *Fairbanks, Morse* case, *supra*, the taxpayer had purchased all of the capital stock of another corporation. As part of the purchase agreement the taxpayer became obligated to provide the subsidiary corporation with necessary working capital by way of inter-company loans or advances on open accounts from the taxpayer to or for the subsidiary; or at the option of the taxpayer by purchasing additional capital stock of the subsidiary. In holding the advances to be deductible, the court stated:

"Whether the funds advanced by the plaintiff as the sole owner of the stock of Home Appliances, Inc., were loans or contributions to capital depends entirely upon the circumstances under which they were made. Such advances would be additional contributions to capital only if they had been intended to enlarge the stock investment and had not been intended as loans. *Edward Katzinger Company v. Commissioner*, 44 B.T.A. 533. Here the parties intended these advances as loans. This is shown by the character of the transactions. The plaintiff carried on its books an open account with Home Appliances, Inc. In this account the payments and advances were charged to the subsidiary and remittances were credited to the account. The plaintiff did not purchase any additional capital stock of the subsidiary. The contract whereby plaintiff acquired the stock of the subsidiary provided that advances made by the plaintiff should

be in the form of inter-company loans or advances on open account unless plaintiff purchased additional capital stock of the subsidiary."

Lucia Chase Ewing, supra, was a case in which a danseuse exhibited her enthusiasm for her art by advancing some \$300,000.00 to an incorporated ballet group of which she was the sole stockholder. In sustaining the claimed deduction the court based its decision on the intent standard of the *Katzinger* case, *supra*, saying:

"In judging whether or not these advancements by the taxpayer were loans on the one hand, or gifts or advancements to capital on the other, the whole criterion set forth in the cases is as to whether or not the person making the advancements considered them to be loans and expected them to be repaid. . .

"In the case at bar the taxpayer testified that she expected to be repaid; that her expectations were based upon the ultimate 'success' of the company; and, from the whole record, it is shown that she had an over abundance of confidence in that ultimate success. The balance sheets of the corporation show that these advances by the taxpayer were treated by the corporation as loans."

Nor is the purpose for which the loans are made material. It is sufficient that they be made with the intent of obtaining repayment, that is, creating a debt. In the *Van Clierf* case, *supra*, the sole stockholder of a corporation advanced almost \$100,000.00 to it for the sole purpose of sustaining its operations during financial difficulties. In answering the contention of the Commissioner that such advances represented capital contributions rather than loans, the court stated:

"The inference that a loan was intended is the natural and logical inference, and the fact that Van Clierf was the sole stockholder of the corporation did not tend to rebut it The fact that Van Clierf made the advances to keep the corporation afloat rather than to liquidate it, has no tendency to show that a voluntary addition to capital rather than a loan was intended."

A similar situation and decision is presented by *John J. Quinn*, P-H T.C. Memo. Dec. Par. 46,254 (1946).

It is obvious from the way in which the transactions were handled in the case at bar that all advancements were intended as loans and not in any sense as contributions to capital. The Board in sustaining a bad debt deduction in *Ethel S. White*, P-H T.C. Memo. Dec. Par. 47,262 (1947), stated:

"That sums advanced by petitioner to the paving corporations were regarded by all the parties concerned as debts and not donations is established by the books of petitioner as well as the books of the two paving corporations."

The Board virtually repeats this language in refuting the contention that because the petitioner was the principal stockholder the advances should have been considered to be capital contributions. The *Van Clierf* and *Katzinger* cases, *supra*, are similar in their reliance on book entries. By the leases the taxpayer undertook to make the advances only "when required", and he testified that he thought the corporations could get credit on their own (Tr. 161, 162). Expectation of repayment was obviously based upon the expected success of the corporations. This was reasonable in view of war created

demands. The Lebanon corporation fulfilled the taxpayer's optimism (Tr. 119). That the advances secured by the taxpayer's guarantees were not capital contributions is, perhaps, most vividly acclaimed by the fact that such amounts represent obligations incurred by the corporation in the normal course of business for "operating expenses" (Tr. 197). It is common knowledge that most businesses defray current expenses with borrowed funds. This manner of financing has not the concept of permanent investment which the appellants would imply from the dealings.

COMMENTS ON ARGUMENTS OF AND CASES CITED BY APPELLANTS

The appellants have cited *Janeway v. Commissioner*, 147 F. 2d 602 (C.C.A. 2d, 1945) and *Cohen v. Commissioner*, 148 F. 2d 336 (C.C.A. 2d, 1945), for the proposition that the advances represented capital contributions. The basic factor upon which these cases are grounded is that there is no identification or clear separation of capital from debt. Under such circumstances there naturally can be no proof of an intent that advances should represent debts. In the *Janeway* case, for example, the various participants at one time or another made advances to the corporation for which they received notes. As shown by the report of this case in 2 T.C. 197, 202 (1943), for every \$1,000.00 of notes there was issued 6/10ths of a share of stock. The entire stock issue was but 22.8 shares. Petitioner contended the stock was issued as a bonus. The Tax Court at page 202 said:

" . . . we can not hold the stock, although issued in small quantities, to be a mere bonus, of no consequence to the present question; for the fact that the stock was issued in small quantities is immaterial, since the entire stock issue was only 22.8 shares.

" . . . when they received the notes and stock they received pro rata control of the corporation through ownership of its stock in proportion to the amount of money advanced. Had the corporation earned large amounts of money, the petitioners would have been entitled to the whole thereof, that is, in accordance with their portion of the 22.8 shares of stock extant . . . they did receive with the other stockholders in like position as to advancements, the entire issued capital stock of the corporation and all the control and value it entailed, *in proportion to the money which went into the corporation.*" (Italics inserted)

Since the entire capital of the corporation had its basis in these so-called loans, and since all stock was issued in direct proportion to the loans so that the holders would share in the control and profits in proportion to the loans it is obvious that there was no *segregation* of capital from debt. Under such circumstances it was clear that the stock was in fact issued for the advances. The advances, then, could represent only capital.

In connection with that case, the quotation which the appellant has taken from the case should be amplified so as not to be misleading due to its inadequacy. The appellants in their brief (p. 36) quoted as follows:

"Though the advances made were, by the issuance of the notes, given the appearance of loans, the possibility of repayment was no stronger than

the business and its possible success. No other money was paid in for stock, so that the advances constituted the corporation's only source of working capital."

Immediately following this excerpt, the court went on to say:

"Ordinarily a loan to a corporation, if not otherwise secured, has the assurance of capital having been paid into the corporation so that the assets purchased therewith are subject to the payment of the loan. Here the 'loans' constituted *the sole capital*, with no other assets subject to repayment. The effect of what was done is the same as if the petitioners and the other stockholders purchased the stock with the money advanced, and became pro rata owners of the corporation." (Italics inserted)

In the case at bar, as hereinbefore indicated, growers' contracts of a value equal to that of the capital stock of the corporations were paid to corporations for their stock. The testimony shows that the corporations could not have functioned without the growers' contracts (Tr. 146). If the stock had been paid for with money, the corporations would have been justified in using the money to acquire growers' contracts, that is, of course, if they had been able to find contracts that could have been purchased—for without them there could have been no operations. There was no link of any kind between the taxpayer's advances and the growers' contracts or the amount of stock issued.

Where there are no such exceptional circumstances as existed in the *Janeway* case, *supra*, or where there is

no evidence which contradicts the conclusions stemming from the form of the transaction, the payments are considered to be loans, regardless of the fact that the contributor was also a stockholder. *Van Cleef v. Helvering*, *supra*; *William D. P. Jarvis*, 43 B.T.A. 439 (1941). The appellants have pointed to the fact (Br. 36) that the advances were at the "risk of the businesses", but it is a truism that advances made by anyone to a concern are at the risk of the business.

The appellants have made further reference to *Dalton v. Bowers*, *supra* (Br. 35). While their statement about the case is accurate, the quotation respecting the "loss", immediately following the statement that the taxpayer "paid the debts of the corporation", may leave the impression that the loss was derived from the taxpayer's payment of the corporation's debts. This, of course, was not the case. The loss in question there was a stock loss. It is true that the taxpayer paid the debts of the corporation, and when they became worthless debts in 1923 and 1924 he claimed the statutory deduction. For aught that appears the bad debt was allowed.

The only other cases which appellants cite as support for the statement they make at the top of page 35 of their brief are *Burnet v. Clark*, *supra*, hereinbefore discussed, and the two following cases.

American Cigar Co. v. Commissioner, 66 F. 2d 425 (C.C.A. 2d, 1933), was a case in which the taxpayer advanced funds to a corporation in which the taxpayer was a stockholder, knowing at the time it advanced the funds that they would never be repaid and that any

obligations created thereby were worthless and uncollectible. The court held that such advances, made with no intent of repayment, were gifts or contributions to capital. From what has already been said it is obvious that in the case at bar there was reasonable expectation that the corporations would be able to pay their obligations, which the taxpayer guaranteed.

Corn Exchange National Bank & Trust Co., 46 B.T.A. 1107 (1942), is completely inapposite. The situation there was one in which the taxpayer undertook to pay all liabilities to creditors of another bank in exchange for all the assets of the latter. On the assets transferred to the taxpayer, the latter realized an amount less than the liabilities it had assumed. The question presented was whether the relation of debtor and creditor existed between the taxpayer and the other bank, so that it might claim the loss sustained on the sale of the assets transferred to it as a bad debt. The Board held that there was no such relation, saying:

“Under the stipulated facts all obligations of Union and its stockholders to Corn Exchange ceased when the latter took over Union’s assets and assumed its liabilities.”

The following suggestion is made by appellant (Br. p. 37):

“The taxpayer’s arrangement under the leases with his three cannery corporations whereby he furnished all the working capital (R. 104, 123, 157, 159) and eventually, upon their liquidation, withstood all the resulting losses, might well be considered to have constituted payments made under

the contracts indemnifying the corporations against losses on their notes, . . .”

That shows a misconception of the facts. The “financing” clause of each lease was an undertaking of the taxpayer to assist in financing when required, and was not an undertaking whereby he agreed to insure the corporations against loss on their future operations. The obligation which the taxpayer assumed under the lease was independent of loss and would have been binding in the absence of loss. The controlling detail is the manner whereby the taxpayer fulfilled the obligation which he had thus assumed, and the court found that he did this by guarantee and as a surety. The court found that the Dehydrator corporation owed the plaintiff the sum of \$61,115.48 on account of accounts payable of said corporation, which plaintiff had previously guaranteed and did pay, and on account of notes payable of said corporation, upon which the plaintiff was surety and which the plaintiff did pay, and that the Yakima corporation owed the plaintiff the sum of \$33,966.02 on account of, among other things, sums advanced by the plaintiff to said corporation to pay promissory notes of said corporation upon which plaintiff was surety and which sums were used by it to pay said notes (Tr. 71-72). It must be stated flatly that by no exercise of the imagination is it possible to stretch a contract of guarantee into a contract of indemnification. The cases which appellants cite at the bottom of page 37 of their brief with the exception of *Howell v. Commissioner*, 69 F. 2d 447 (C.C.A. 8th, 1934), do not even deal with the problem of indemnification. The *Howell* case while correctly

summarized is also not pertinent to this argument, as we have just pointed out, because there is no contract of indemnification involved here.

Near the top of page 18 of their brief appellants say that the net operating losses are alleged to have been suffered because of the taxpayer's guarantees to pay obligations of the corporations. Those losses were suffered because two of the three corporations failed to make sufficient profits to pay their obligations. It was only because of the failures of two of the corporations that taxpayer was called upon to satisfy their obligations that he had guaranteed. Had these two corporations been successful they could have been able to pay their debts.

At page 18 of their brief appellants say that upon liquidation (of the corporations) the taxpayer satisfied their outstanding obligations and it is this amount and the advancements which he claims as a carry-back loss. This is true as far as it goes, but overlooks the fact that the outstanding obligations were satisfied by the taxpayer only because of his pre-existing guarantees.

The appellants have sought to distinguish the *Katzinger* case, *supra*, by pointing out that the Board refused to allow deductions on the same loss for both the years 1933 and 1936. Lest there be any doubt, however, that the Board found a bad debt (although it allowed only a portion thereof due to the prior deduction taken in 1933), the following portion of its opinion is quoted:

"The respondent argues that all of the funds advanced by the petitioner must be regarded as ad-

ditional capital contributions since Bruce-Hunt had to have more than \$1,000 with which to conduct its operations. He cites no authority in support of this argument and we know of none. Funds advanced by shareholders to their corporation may or may not be contributions of capital, augmenting the cost of the shares, depending upon the circumstances under which the advancements are made. Advances are an additional contribution of capital if they are intended to enlarge the stock investment, but not if they are intended as a loan. . . . We hold that the petitioner sustained a loss of \$28,950.06 from a debt which it ascertained to be worthless and charged off in 1936."

CONCLUSION

The findings of fact and conclusions of law of the District Court are correct, and the judgment of the District Court should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code:

Sec. 23. DEDUCTION FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(k) Bad Debts.

(1) General Rule. Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection. This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

(4) Non-Business Debts. In the case of a taxpayer, other than a corporation, if a non-business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months. The term "non-business debt" means a debt other than a debt evidenced by a security as defined in paragraph (3) and other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(s) Net Operating Loss Deduction. For any taxable year beginning after December 31, 1939, the net operating loss deduction computed under Section 122.

Sec. 122. NET OPERATING LOSS DEDUCTION.

(a) **Definition of Net Operating Loss.** As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).

(b) **Amount of Carry-Back and Carry-Over.**

(1) **Net Operating Loss Carry-Back.** If for any taxable year beginning after December 31, 1941, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed (A) with the exceptions, additions, and limitations provided in subsection (d) (1), (2), (4), and (6), and (B) by determining the net operating loss deduction for such second preceding taxable year without regard to such net operating loss.

(d) **Exceptions, Additions, and Limitations.** The exceptions, additions, and limitations referred to in subsection (a), (b), and (c) shall be as follows:

(5) Deductions otherwise allowed by law not attributable to the operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of the gross income not derived from such trade or business. For the purposes of this paragraph deductions and gross income shall be computed with the exceptions and limitations specified in paragraphs (1) to (4) of this subsection.

